Tax Incentives – One More Lever for the Government's Energy Policy

G Nightingale and S Smith

Ernst & Young Ltd, PO Box 490, Wellington. Tel 64 4 499 4888. *geof.nightingale@nz.ey.com* spencer.smith@nz.ey.com

1. Introduction

In the post-Maui environment there are calls from many sectors for increased levels of petroleum exploration and development. Is tax one of the levers that the Government could use to attract, encourage and direct that activity?

For investors assessing competing exploration and development ("E&D") projects a host country's fiscal regime, including income tax, is a key consideration as this can significantly affect a project's profitability and cashflow.

Since the mid-1980's NZ has followed a low rate, broad base tax philosophy. As a result, successive Governments have actively removed incentives from our tax law and attempted to avoid the use of tax incentives in fiscal and economic policy. The view of Government and officials was that such incentives distorted economic behaviour in unintended ways, clouded market signals and lead to a less efficient allocation of resources in the economy:

> "*National welfare is maximised when investments with the highest pre-tax returns, adjusted to take account of risk, are undertaken. This will not be the case if some risky activities are subsidised through the tax system*" [1]

Recent Government initiatives indicate that this view is softening and the Government appears increasingly prepared to intervene or incentivise behaviour in the interests of economic and social development.

In this context, and in light of sector calls for urgent Government action to encourage petroleum E&D in New Zealand, it is possible that we will see the Government reconsidering the tax and royalty regime for petroleum E&D.

The current income tax regime for E&D in New Zealand is relatively straightforward and in comparison with the general tax regime it is, arguably, already very favourable (more on this later). However, at present it (again arguably) does not include explicit or headline incentives that might directly and overtly provide tax incentives to foster E&D activity.

The purpose of this paper is to provide an overview of the current income tax regime[2] and comment on the types of tax incentives that the Government might consider.

In particular, this paper will:

- Examine the broad features of the current E&D tax regime;
- Comment briefly on the recent history of New Zealand's approach to E&D tax regimes;
- Identify current obstacles and potential disincentives in New Zealand's E&D tax regime, including New Zealand's tax loss rules, GST and joint ventures, the exploration expenditure claw back and tax issues regarding the use of foreign expertise and equipment;
- Briefly comment on New Zealand's E&D income tax regime in comparison to E&D tax regimes in other parts of the world; and
- Evaluate the types of E&D tax incentives that Government might consider in the event it decides that its energy policy imperatives support such an approach.

2. The current E&D tax regime

Income tax in New Zealand is principally governed by the Income Tax Act 1994 ("the Act"). The Act adopts a gross/global approach whereby income tax is payable on "taxable income". Taxable income is arrived at by returning annual gross income and claiming annual allowable deductions and available net losses.

The gross income of a petroleum miner is largely determined under the general provisions of the Act, with an overlay of some specific provisions that apply to the taxpayer's petroleum mining interests.

The deductibility of E&D expenditure is critical in determining the amount of income tax payable by a petroleum miner. Also of importance are the rules relating to the timing of deductions and the ability to carry forward and offset losses as these provisions determine when income tax is paid.

---

[1] 1987 Consultative Document on Petroleum Mining Taxation, Government, section 3.

[2] This paper principally deals with income tax issues only, touching on some GST and withholding tax matters. It does not consider royalties or the wider fiscal regime relating to petroleum mining. It also focuses on the general taxation regime for petroleum miners and does not consider the unique rules applying to the historic Maui field.

We briefly outline each of these key areas of the current E&D regime.

2.1 Deductibility of E&D expenditure

Expenditure on petroleum mining is broadly categorised as either exploration expenditure, development expenditure, or residual expenditure. The various types of expenditure are discussed below. We also discuss several other specific items of petroleum income and expenditure that are important features of the current regime.

Exploration expenditure

The term "exploration expenditure" in this context, means exploratory well expenditure, prospecting expenditure, expenditure incurred in acquiring a prospecting licence, a prospecting permit or an exploration permit. It does not include any residual expenditure or development expenditure.

Exploration expenditure is allowed as a deduction in the year that the expenditure is incurred. However, where an exploratory well is subsequently used for the commercial production of petroleum, the exploration expenditure that has been deducted in respect of that well is "clawed-back" by being required to be added to the gross income of the petroleum miner. The expenditure incurred is then treated as development expenditure and deducted over 7 years on a straight-line basis (refer below).

Development expenditure

"Development expenditure" is expenditure relating to the development of a permit area once petroleum is discovered, including costs relating to planning, constructing, or acquiring petroleum mining assets. Development expenditure does not include any expenditure to the extent that it is residual expenditure, exploration expenditure, or any other expenditure that is allowed as a deduction under any section of the Act.

Development expenditure in respect of onshore projects must be capitalised and deducted over 7 years beginning from the date of first commercial production. For offshore projects, development expenditure is deducted over 7 years beginning with the income year in which the expenditure was incurred.

Residual expenditure

Excluded from the definition of both exploration expenditure and development expenditure is residual expenditure.

Residual expenditure is defined to consist of:

- expenditure on scientific research other than capital expenditure;
- an application fee paid to the Crown in respect of a petroleum permit or petroleum licence;
- insurance premiums, royalties paid under the Petroleum Act 1937 or Crown Minerals Act 1991, rates or interest;
- interest or expenditure under a financial arrangement; and
- lease expenses

Residual expenditure is deductible in the year in which it is incurred, subject to the ordinary deductibility rules.

Other Specific Items of Petroleum Income and Expenditure

- Removal or Restoration Expenditure

An immediate deduction for removal or restoration operations is permitted in the year in which the expenditure is incurred. It is recognised that these costs will arise after the well has ceased production. Accordingly any loss arising in a year where a permit is relinquished or removal or restoration operations have been carried out that cannot be offset can be carried back and offset against prior year profits.

- Relinquishment of Petroleum Licence

Where a petroleum permit or licence is relinquished, any deferred deductions that have not been deducted previously shall be deductible in the year of relinquishment.

- Disposal of Petroleum Mining Assets

Consideration received by a petroleum miner from the disposal of a petroleum mining asset is gross income in the year that the consideration is derived. Any undeducted deferred expenditure will be deductible at that time.

Where a petroleum miner sells mining assets to an associated person the deduction available to that petroleum miner is limited to the extent of net income derived from the associated person in respect of that sale.

- Farm-Out Arrangements

Generally the farm-in party's contribution to exploration or development work undertaken on a petroleum licence area is deductible to the farm-in party according to whether it is exploration or development expenditure. The farm-in party's contributions are specifically excluded from being taxable income for the farm-out party.

- Disposal of Petroleum Mining Shares

New Zealand used to tax the profits on the sale of shares in any "controlled petroleum mining entity". However, that section has been repealed and the proceeds of sale of such shares are deemed not to be gross income in New Zealand.

2.2 Tax losses

In principle, petroleum mining companies are subject to the same rules regarding tax losses as other taxpayers.

Losses that are incurred can be carried forward to be offset against income in subsequent years. There is a requirement that the company satisfies a 49% continuity of shareholding test. This requires that a common group of persons has held a minimum 49% voting interest in the company at all times from the beginning of the year of loss until the end of the income year in which the losses are utilised.

Further, losses can be offset against the income of other New Zealand companies in the same group. To be in the same group the companies are required to have at least 66% common ownership, however, losses incurred by a dual resident company cannot be offset in this manner. Losses can be offset by election, subvention payment, or a combination of both. Subvention payments can equal the full amount of the losses, and can therefore be a useful mechanism to fund a loss making company or branch.

Where the 49% shareholding continuity requirement has been breached during an income year as a result of a change of shareholding, or the 66% shareholder commonality requirement threshold for loss offsets is not met as a result of an acquisition or disposal of shares, there are provisions that provide part-year loss carry forward or offsets. The provision requires part-year accounts to be prepared apportioning the year around the date of the breach.

3. Historical context

The recent history of the income tax rules applying to E&D activity in New Zealand is quite interesting. It clearly highlights the Government's changed philosophy in its design of the tax system that commenced in the mid-1980's but it also reinforces that the market will react to the signals that it is sent by Government via its tax laws.

From 1 April 1979 until 1 October 1990, New Zealand provided a quite deliberately incentivised tax regime for petroleum miners. However, from about 1985 onwards, these concessions came under increasing pressure. The objective of the then Government (as foreshadowed in the introduction to this paper) was to move towards a more neutral tax system.[3]

In the 1986 Budget the then Minster of Finance, the Hon Roger Douglas, announced the Government's intention to withdraw the income tax "concessions" available to petroleum mining with effect from 1 April 1988.

The "concessions" of the then regime included:

- an immediate deduction for exploration expenditure;
- a 5 year write-off for development expenditure;
- the ability to "pass-through" petroleum mining losses to proportionately to shareholders;
- the ability of a petroleum miner to treat farm-in expenditure as its own E&D expenditure
- concessionary tax loss carry-forward rules.
- a limited deferral of tax on the profits of the sale of shares in a petroleum mining company;
- a 1/3rd deduction for a shareholder on calls on certain shares in a petroleum mining company (repealed from 1 April 1986);
- certain tax rebates on income from a deep-sea petroleum mining licence (also repealed from 1 April 1986).

The proposed new regime was set out in a 1987 Consultative Document on Petroleum Taxation issued by the Government. Broadly, the Government's tax policy objective was to tax petroleum mining activities on the same classical approach to income tax that applied to other activities so as to achieve tax neutrality and to scale down the Government's assistance to the industry via the tax system.

The regime proposed basically required capitalisation of all exploration and development costs. Exploration costs for unsuccessful exploration would be deducted in the year a well was abandoned but exploration costs for successful wells would be deducible on an extraction basis over the life of the field. Development costs and other assets were to be depreciable on basis equivalent to other industries.

The new approach proposed by the Government was not perceived to be neutral by the industry and extensive submissions were made. As a result of industry reaction, the implementation of the proposals was deferred by the Government and substantially amended. Finally with effect from 1 October 1990, the "new" regime for petroleum mining was introduced.

The "new" regime allowed a deduction for petroleum mining development expenditure (broadly both exploration and development expenditure as we would use those terms today) over 10 years commencing from the date of first commercial production (with the remaining balance deducted if the interest was sold or abandoned).

The petroleum mining industry still disliked the new regime and felt that it made New Zealand internationally uncompetitive. Anecdotal evidence from that time indicates that in response to the "new" tax regime, the willingness of the industry to commit to further expenditure on petroleum exploration and development was significantly reduced. This outcome made the new Government reconsider the petroleum mining income tax regime. Indeed, the industry made such a good job of getting its message across to Government that by 1992, even Inland Revenue seemed to accept that the "new" regime was undesirable, witness the language used in the Inland Revenue's March 1992 Tax Information Bulletin that announced the change:

> *"The Government has announced its intention to introduce new tax legislation affecting the petroleum mining sector. The legislation is intended to eliminate the current punitive tax treatment of petroleum exploration and development expenditures, both onshore and offshore."* [4]

As a result of this decision by the Government, the current petroleum mining income tax regime discussed in section 2 of this paper was enacted in 1992 with effect mainly from 1 October 1990, to a large degree repealing the previous "new" regime. However, the 10-year deduction spread was retained for petroleum mining development expenditure incurred

[3] 1987 Consultative Document on Petroleum Mining Taxation, Government, section 4.
[4] TIB Vol 3., No. 5, March 1992, Inland Revenue, Appendix B: Petroleum Mining Legislation.

between 1 October 1990 and 16 December 1991. The Government's intention in enacting the new regime was to *"…achieve broad international comparability of tax treatment of petroleum exploration and development expenditure, both onshore and offshore."* [5]

A number interesting observations could be made from this brief history:

1. It is not clear that the historical income tax incentives actually increased E&D spending but, at least anecdotally, their removal in 1990 threatened existing and new levels of spending.
2. While a neutral tax system is theoretically a sensible underpinning to the efficient and effective allocation of resources, markets do not necessarily react in the ways predicted by the policy makers.
3. Governments in New Zealand are prepared to react on a pragmatic basis to actual market responses if those responses are considered sufficiently material to the economy.
4. Governments in New Zealand recognise the need to evaluate the New Zealand tax regime in comparison to international approaches and respond where New Zealand's competitiveness is threatened.

In light of these observations and predictions of a looming short-term energy shortage, it would seem that the climate is right for the Government and industry to review the fiscal terms again including the petroleum mining tax regime. Indeed, we understand that this process is underway within Crown Minerals.

4. Current issues with the tax regime affecting petroleum mining

When it comes to petroleum exploration, New Zealand is highly dependent on foreign expertise and capital. Given this, foreign companies considering an investment in New Zealand are (in the authors' experience) often surprised to learn that there are no explicit tax incentives for petroleum E&D in New Zealand[6].

However, there are other tax issues that we have found annoy and discourage foreign companies. Some of these are not unique to petroleum explorers. Indeed, the present Government appears to be very aware of the burden that an overly bureaucratic system can impose, as demonstrated in the introduction to a recent Government Discussion Document – "Making tax easier for small businesses" [September 2003].[7]

In the authors' opinion, the Government would do well to consider the benefits from extending the helpful thinking in the Discussion Document to all participants in the New Zealand economy.

The popular perception of exploration companies is that they are large and they have very deep pockets. As participants at this conference are aware, this is far from true for the great majority of explorers. And even those that do have good resources, rail at certain tax rules that they perceive as unfair and wasteful. Below we briefly catalogue some of these issues:

4.1 Tax losses

To carry forward tax losses, New Zealand tax rules require that companies retain 49% shareholder continuity between the income year that the loss arose until the end of the year that the loss is offset against a profit. Shareholder continuity is traced through to the ultimate shareholders, subject to some concessions for ordinary trading of shares in listed companies.

Consequently the New Zealand tax losses of a New Zealand branch or subsidiary are potentially vulnerable to any offshore corporate reorganisation in the foreign parent company.

The loss carry forward rules also mean that caution is required introducing new investors. Inland Revenue would point out that investors do have some options to selling shares, such as a direct sale of assets (to create taxable income), or farming out (not taxable to the farm out party). However, the result of the current rules is sometimes to create additional compliance simply to preserve something to which the E&D company might consider it should be entitled to as of right.

Further, in our experience, the tax benefit of E&D tax losses is frequently never realised. Foreign E&D investors usually have no other profit making activities in New Zealand to offset exploration losses against. They are also unable to sell their New Zealand subsidiaries with tax losses intact. Other countries have a same business test that allows shareholders to monetise at least some of the tax benefit on a sale of shares.

4.2 Clawback of deductions

The New Zealand tax rules provide that the cost of an exploration well may be clawed back (i.e. treated as taxable income) where it is converted to commercial production. The expenditure is then reclassified as development expenditure with a 7 year amortisation. While the rule is not

[5] TIB Vol 4, No.5, December 1992, Inland Revenue.
[6] Although, as we explain in other parts of this paper, the effective income tax rate for petroleum miners is actually between 14 % and 21%, rather than the headline rate of 33%.
[7] The Discussion Document defines the large employer as one that deducts over $100,000 in PAYE and specified superannuation contribution withholding tax a year (having about ten or more employees).

unfair in itself, its effect can be very costly where the clawback is combined with the earlier forfeiture of tax losses (see above). Investors, particularly those acquiring an interest in an existing company, can also overlook it.

There are no statutory guidelines as to whether the clawback will apply only to direct costs.

4.3 Foreign expertise, services and equipment

The presence in New Zealand of employees of a foreign parent may inadvertently create an obligation to file a New Zealand branch tax return on behalf of the parent and create withholding tax difficulties.

New Zealand imposes a withholding tax on payments to non-residents for contract services performed in New Zealand. Exemption certificates are available but to obtain an exemption certificate in the first instance generally requires the non-resident to be exempt from New Zealand tax on that income under one of New Zealand's double tax treaties. Unfortunately, New Zealand treaties are not entirely helpful in the area of petroleum mining activities.

New Zealand's treaties with its major trading partners (in particular, USA, UK and Australia) contain definitions of a "permanent establishment" that include any activity carried on in connection with the exploration or exploitation of natural resources. The words "in connection with" are potentially capable of including any services, even those that only indirectly relate to the E&D activities carried on.

Where a permanent establishment of a foreign firm exists in New Zealand, its revenues related to that activity are taxable here.

The treaty with the USA does permit some short-term presence in New Zealand of less than six months in aggregate in a consecutive twelve month period. However, the rule is problematic for longer term contracts. The treaties with the UK and Australia have no time rule, and therefore one day in New Zealand could technically create a New Zealand tax return obligation.

The same problems apply to visiting independent experts and industry service providers. The problem cascades as well because once a permanent establishment exists then the rules under the relevant tax treaties exempting foreign employees from tax in New Zealand for short visits no longer apply resulting in the need for the foreign employer to deduct and pay PAYE and pay FBT to Inland Revenue.

Even where a permanent establishment can be avoided, many of New Zealand's treaties will classify equipment rental payments relating to equipment owned by a non-resident and used in New Zealand as royalties, effectively subjecting those revenue streams to tax in New Zealand.

In practice it is likely that much of the additional cost this creates for the service providers is passed on to the petroleum miner either directly via "gross-up" type clauses or indirectly via higher pricing.

There has been some official recognition of the compliance problem by Government with recent developments around withholding tax, but the relief offered is limited:

a) Persons with treaty exemption are no longer required to apply for a certificate of exemption where the visit is less than 92 days. However, this doesn't help those experts coming from Australia or the UK, as they are deemed to have created a permanent establishment in New Zealand (and therefore have no treaty exemption).

b) Persons making payments to a non-resident contractor are not required to deduct withholding tax where the total payments to that contractor are less than $15,000 in any period of 12 months. While this may take the deduction burden off the payer, it does not relieve the payee from the obligation to file a New Zealand tax return and pay tax here.

4.4 Employee remuneration issues

Seconded employees will frequently have medical and superannuation plans in their home country. They may also have share option plans. These benefits are potentially liable to fringe benefit tax (FBT) or income tax in New Zealand. Further, due to the type of tax, or differences in the timing in the recognition of the benefit, there may be no treaty relief for the individual, rendering the benefit liable to double taxation.

There are special rules for persons who have investments in foreign trusts and foreign investment funds that are potentially complex in their application.

Our experience is that foreign owned companies face significant costs assisting their expatriate employees with complying with these rules, and if necessary, calculating how to compensate their employees for the additional tax costs.

Inland Revenue has recently released a discussion document examining these costs and contemplating solutions and this is positive[8]. Officials are currently evaluating the sub-missions and developing the policy response. However, whether the natural conservatism of Government and officials around protecting the revenue base will restrict the value of any amendments remains to be seen.

4.5 Petroleum mining

There are certain technical aspects of the current petroleum mining tax rules that need revision to take account new technology and practices. One example would be the definition of "offshore development". What is the position

[8] Reducing tax barriers to recruitment to New Zealand, 11 November 2003 Government, Inland Revenue.

where an onshore platform is using lateral drilling techniques to drill below the waterline? Where there are both onshore and offshore facilities, is the question of the position of the "major part of the facilities" based on their significance or expense, or some physical notion of size or proportion?

4.6 GST on joint ventures

The Goods and Services Tax Act 1985 ("the GST Act") states that, where a joint venture is registered for GST in relation to a taxable activity, none of the members of that body shall be registered or be liable to register in relation to that taxable activity. Yet, it is common for joint venture partners to incur costs that are separate to those incurred by the joint venture, and to incur GST on those costs. If the partners are not carrying on a taxable activity (because the joint venture is deemed to be doing so), they may have no ability to claim back the GST.

There are provisions allowing the sale of a going concern to be zero-rated, which means that no GST is payable or refundable. However, the transfer of joint venture interests is, in our experience, usually standard rated at 12.5%. This is not necessarily because the assets are not a going concern, but because tax advisors want to avoid any opportunity for Inland Revenue to allege that GST should have been paid. This creates a GST tension where the acquirer is not registered for GST and may struggle to register for GST if the joint venture provisions deem its taxable activity to be carried out by the joint venture.

While the authors have personally found Inland Revenue's E&D specialists to be reliable and helpful, we perceive that there is, from the tax advisors' side, some concern regarding the way in which Inland Revenue may deal with this issue under audit. Certainly a clear interpretation standard on this issue would be helpful but it may actually require a law change to fix.

4.7 GST on restoration costs

There are possible issues claiming back the GST incurred on site restoration costs.

The GST Act deems anything done in connection with the beginning or ending of a taxable activity as being carried out in the course or furtherance of that taxable activity. Therefore, one would expect that an E&D joint venture would be able to claim back the GST incurred on site restoration costs. However, in a binding ruling application on the matter, Inland Revenue initially took the position that these costs would not qualify, as the definition of "input tax" contemplates that supplies be acquired before or roughly contemporaneously with supplies made. In the end, the ruling was issued because Inland Revenue accepted that the sale of the site would attract GST and the site had to be restored in order to be sold.

We have raised this problem informally with Inland Revenue policy experts, who have expressed some surprise that it should be a problem. However, there should be no doubt about this issue. To get the ruling, we were also required to prove that restoration of a site is a legal requirement. The experience left our offshore client frustrated and concerned with the officials' approach.

Conclusions on current problems and issues

The authors hope that the above list does not discourage investors contemplating an investment in E&D in New Zealand. Many of the above problems and frustrations may not become apparent until some time after the investors have decided to invest in a project in New Zealand (which is possibly fortunate for New Zealand).

However, New Zealand's tax policies for petroleum E&D, and its rules affecting visiting technical specialists and industry service providers are very much in the "shop window". They say a lot about the official attitude to E&D, and it is understandable that potential investors will be more attracted to countries that clearly have the "welcome mat" out. There are signs that the Government is hearing this message, and we remain hopeful that our tax rules for E&D investment in New Zealand will continue to be improved and simplified.

5. New Zealand's regime in comparison to others.

The current New Zealand income tax regime for petroleum mining is arguably already a concessionary regime (although there are issues as outlined in the previous section of the paper). This conclusion can be reached if the current regime is compared to the base case of a classical approach where the capital costs of establishing a business are capitalised and amortised over the life of the relevant assets. The base case and current regime are then evaluated by comparing effective tax rates for a given investment based on a very simple set of assumptions including:

- the ratio of successful wells to unsuccessful drilling
- the cost of drilling
- the cost of development
- the life of the field and likely revenue
- the operating costs.

The effective tax rate in this instance is calculated by comparing the pre-tax internal rate of return for the exploration and development profile assumed with the post-tax internal rate of return for the same data under an assumed set of tax rules taking a classical approach and with those same internal rates of return calculated under the current petroleum mining tax regime.

Using this methodology, effective tax rates under the classical approach tend to around 30% (compared to a headline tax rate in New Zealand of 33%) while under the current petroleum mining tax regime, the effective tax rates vary between 14% and 21% depending on whether or not

the early year losses are assumed to be carried forward to be used against future profits (21%) or are used on a current basis against another tax base in New Zealand (14%).

So how then does New Zealand compare to other regimes? It is of course of little real comparative value to simply compare New Zealand's income tax regime with other regimes as what is actually relevant to an industry participant is the impact of the overall fiscal regime in each jurisdiction, of which income tax forms only a contributing factor.

Recently, the Crown Minerals section of the Ministry of Economic Development has commissioned two reports by Wood Mackenzie comparing fiscal regimes between New Zealand and other countries:

- In March 2003, Wood Mackenzie reported on the economics and comparative return on investment for a New Zealand deepwater petroleum filed compared with typical fields in four other areas, Angola, Brazil, the Gulf of Mexico and Nigeria ("the deepwater study").[9]
- In September 2003, in a wider analysis, Wood Mackenzie presented a comparative study of New Zealand's fiscal terms with those of seven other countries being Argentina, Alaska, Australia, Egypt, Indonesia, Norway, and the United Kingdom ("the fiscal terms study").[10]

Wood Mackenzie's methodology in both studies involved modeling selected fields in the countries under the home country fiscal regime and then, using the same data, modeling the field performance under the New Zealand fiscal regime. Among other comparatives, Wood Mackenzie used pre-tax and post-tax internal rates of return to highlight the differing 'Government take' for the various selected fields and countries. Wood Mackenzie's analysis differed to our simple hypothetical model discussed above as they included royalties or similar Government charges as tax so as to compare the total Government take between the New Zealand fiscal regime and the home fiscal regime.

Wood Mackenzie's work in the fiscal terms study showed effective tax rates for the foreign fields when restated under New Zealand fiscal terms ranging between 10.5% and 54.4%, with an average effective tax rate of 31.5%[11]. This accords largely with the simple hypothetical model discussed above where if royalties are included, the effective tax rate climbs to between 28% (tax loss offset) and 34% (no tax losses offset, the Wood Mackenzie assumption).

In contrast, the Wood Mackenzie data for the foreign fields when analyzed under their home country fiscal regimes showed effective tax rates (including royalties and similar Government charges) ranging between 17.8% and 77.4% with an average of 45%. Clearly, against this particular sample, it seems that New Zealand's fiscal regime is certainly competitive in world terms.

Wood Mackenzie reached a number conclusions in the fiscal terms study including[12]:

- With the exception of the UK, the fields analysed generally produced higher present values under New Zealand fiscal terms than under their home country terms.
- The UK fiscal regime post March 1993 is based on a headline corporate tax rate for E&D activities of 40% with no royalty. While New Zealand headline corporate tax rate is only 33%, the 20% accounting profits royalty results in a greater Government take than in the UK.
- Two of the Australian fields analysed produced slightly better present values under Australian fiscal terms than under New Zealand fiscal terms as a result of being operated under favorable state based royalty programme compared to the federal profits based royalty approach.
- Overall, New Zealand has fiscal terms that, on a world basis, are commonly seen as competitive by operators.

New Zealand's own fiscal regime, while significant in the eyes of a potential foreign investor, is only part of the picture. Also relevant, but outside New Zealand's direct control, is the treatment of the New Zealand investment by the home country fiscal regime. For example, in 2001, Brian Purdy in an article analysing the competitiveness of the Australian income tax regime for exploration and production noted that:

"Australian resource companies are inhibited by the local [Australian] *tax system in a number of ways. Australian companies, unlike many of their major global competitors, are unable to obtain a tax deduction in Australia for expenditure incurred in undertaking foreign exploration. This makes the cost of foreign exploration…significantly more expensive for Australian companies."*[13]

New Zealand has little control on the level and nature of the taxation that may be levied by the foreign investor's home jurisdiction on the New Zealand activities although this will generally be critical to an investor's analysis of the project economics.

---

9 Wood Mackenzie, Comparative Deepwater Economics, March 2003, New Zealand Crown Minerals.
10 Wood Mackenzie, Comparative Fiscal Terms, September 2003, New Zealand Crown Minerals.
11 Extrapolated from Wood Mackenzie's pre-tax and post-tax IRR reporting with negative results excluded, Comparative Fiscal Terms.
12 ibid. p.332.
13 Purdy B., How Competitive is the Australian Income Tax Regime for Exploration and Production?, AAPEA Journal 2001, pp.793-802 at p.801.

However, based on this brief review, it does seem possible to conclude that New Zealand's tax regime when considered as part of New Zealand's overall fiscal terms, is internationally competitive, and, when taken together with New Zealand's low country risk profile, it makes (as Wood Mackenzie conclude) New Zealand relatively attractive to petroleum miners.

However, the question that is increasingly being asked is whether that is enough to encourage the level of investment in E&D that many commentators believe that New Zealand needs to secure its economic future.

6. Income tax incentives Government might consider

Despite New Zealand's relatively attractive fiscal terms, if Government wishes to further foster increased investment (both local and foreign) in E&D expenditure it may again consider tax incentives. It is beyond the scope of this paper to address the debate around the effectiveness or otherwise of tax incentives, or to consider other alternative methods of Government intervention into the E&D market. We have simply raised options that Government might consider if it does decide to use the tax system to overtly encourage E&D activity. This is by no means a comprehensive list but simply focuses on some potential ideas that might easily fit into the current structure of the regime.

Realistically, any Government considering using tax incentives faces political risks and pressure from competing lobbies. In addition, tax incentives raise fiscal risks because Governments are unable to directly control the extent to which they are taken up by the market. Each of the incentives discussed below will have application to other industries and businesses and any move by Government to introduce measures targeted at E&D expenditure will without doubt see increased pressure on Government from other interest groups.

6.1 Address the current tax issues

We would certainly advocate that as a minimum, the Government looked hard at addressing the current tax issues identified in section 4 of the paper. Such action is less the providing of tax incentives and perhaps better described as removing or reducing potential barriers to further investment in E&D.

Some of the issues are relatively easy to fix and the solution should be fiscally neutral. For example, settling the issues around GST treatment of joint ventures should reduce risk and compliance costs for parties transacting in this area without disrupting GST revenues.

Other fixes may not be fiscally neutral, but it is possible that their overall economic cost may be low. For example, addressing the issue of short-term services provided by non-residents in connection with petroleum mining not being sheltered from New Zealand tax in a number of New Zealand's double tax treaties. While there may be an apparent tax revenue loss from this, on the basis that this cost is often "grossed-up" and passed on to the petroleum miner anyway, the benefit may be that the costs of E&D reduce thus more activity is possible or projected returns are better leading to increasing interest in New Zealand.

6.2 Tax holidays

A feature of some country's tax regimes is tax holidays where a new entrant can negotiate a period of no tax with the host Government. This could be considered in New Zealand. Such tax holidays can have a high profile and work as a powerful initial attractant to new investment in E&D in New Zealand. However, they are likely to be costly to administer requiring officials to develop transparent criteria, evaluate applications, negotiate taxpayer specific arrangements and review compliance with the terms. It also possible that such holidays create unwanted outcomes as the recipient investor approaches the date at which the holiday will expire and in terms of perceived equity between different taxpayers.

A reasonable tax holiday will of course have a significant impact on a project's economic outcomes over its lifetime. However, it doesn't provide any assistance in the initial exploration and development stages from a cashflow perspective as the cash benefits only flow once a discovery would have started to pay tax in any case. Therefore it is possible that such a tax holiday may be of interest to a large investor with profitable and cash generative operations elsewhere in the world but it may not provide the same incentive to a smaller petroleum miner without strong cashflows.

6.3 Allow monetisation of E&D tax losses

The monetisation of tax losses would involve allowing a petroleum miner to sell losses generated from E&D activities to other taxpayers in New Zealand, effectively allowing loss trading for this specific industry.

Typically new entrant petroleum miners into the New Zealand market generate tax losses from exploration deductions for a period of years before revenues from successful discoveries start to use those tax losses up. If the petroleum miner does not have other taxable income in New Zealand against which to use those tax losses, then the losses accumulate and carry-forward (subject to shareholder continuity) to be used against profits once revenues from a discovery start to flow.

As the section above on effective tax rates points out, a project's internal rate of return can be significantly improved if the tax losses are able to used by a petroleum miner on a current basis rather than carried forward and used later. However, possibly even more important is the fact that such a provision would provide a cash injection at an early stage of the exploration and development activity allowing a petroleum miner to do more exploration or undertake a planned exploration with less upfront funding. Once

revenues flow from a successful discovery, there will be less or no tax losses to shelter those revenues so cash tax payments would start immediately, however, at least at that point in time the discovery's revenues have generated operating cashflow with which to fund the tax.

6.4 Enhance tax loss carry forward and use

Section 4 of the paper identifies risks regarding shareholder change and the forfeiture of tax losses. If tax losses are able to be monetised as outlined above then there is no need for any further changes. However, in the absence of such a measure, relaxing the rules on loss carry forward and offset for petroleum miners may well result in a lowering of the effective tax rate and an increase project returns, thus making an investment in New Zealand more attractive.

Two aspect of existing tax loss rules could be changed, basically returning the rules to where they were before the 1990 changes. Petroleum mining tax losses could be made less vulnerable to shareholding change by relaxing the continuity requirement. In addition, petroleum mining tax losses could be allowed to flow through to investors on a current basis in proportion to their shareholdings. Both of these measures may raise project internal rates of returns making investment hurdle targets easier to reach with a consequent increase in activity.

6.5 Concessionary development deductions

Under the current regime virtually all petroleum mining related costs are deductible, either immediately or over 7 years. This approach could be enhanced in a number of ways, for example:

- by making all costs deductible as incurred; or
- providing greater than 100% deductibility for development costs either with an enhanced allowance (e.g. 150%) or using a formula based on production (e.g. the greater of 1/7th of development costs or 5% of gross revenues with the 5% continuing for the life of the field).

6.6 PAYE/Withholding tax exemptions

The Government could consider going beyond simply addressing the barrier of a lack of New Zealand exemption via double tax treaties for work by some non-residents in relation to petroleum mining activities and instead provide generous tax exemptions under domestic law for foreign participants servicing the industry. This is likely to encourage the use of international expertise and lower the costs to the petroleum miner of using such expertise, thus allowing more activity for a given level of investment.

Governments need to be careful of course with this type of approach as it can lead to accusations of favouring non-residents over local business, an issue that the Government confronted when it examined and rejected the 18% tax rate across the board for foreign direct investment recommended in 2001 by the McLeod Tax Review Committee[1414] Final Report of the Tax Review, 12 October 2001.

6.7 Cash rebates for development expenditure

Funding requirements peak around the time that a successful discovery is being developed to full commercial production. On a project feasibility basis it is possible that simply funding the project on a cash basis is more important in the short-term than the project's nominal internal rate of return. One concept could be for the Government to substitute the deductibility of development expenditure with direct cash rebates for development expenditure. In effect, Government would be directly contributing to the cost of bringing discoveries to production rather than making an indirect contribution via delaying or reducing its tax take.

6.8 Apply a 0% tax rate to petroleum mining

A reasonably radical option would be to remove income tax altogether from petroleum mining activities. The Government could raise its desired revenue from petroleum mining via the royalty regime only. This would remove significant complexity and compliance problems for petroleum miners, free up Inland Revenue resource devoted to this area and provide a significant headline attractant to non-residents considering global investments in E&D.

There are tax policy compliance and design problems with such an approach as tensions and weakness arise in the tax system whenever there is a taxable/exempt boundary. However, it would certainly be an attention grabbing action that would roll out the "welcome mat" to new investment. Of course, the authors as tax advisors in this area do not necessarily think that this is the best approach!

7. Conclusions

While New Zealand seems to have an attractive tax regime for petroleum mining, both when compared to the headline tax rate of 33% and when compared to a range of foreign jurisdictions, there are areas that Government could consider to make it even more attractive. In particular, addressing some of the current problems outlined in section 4 would assist. If the Government is considering using express tax incentives to improve the attractiveness of the industry to participants then there are a number of measures it might consider including tax loss concessions, enhanced deductibility and even direct cash rebates.

Acknowledgement

The authors acknowledge the assistance provided by Greg Lawn, consultant, of Ernst & Young Ltd in preparing this paper.

Authors

GEOF NIGHTINGALE is a tax director of Ernst & Young Ltd who has advised clients in a number of areas of the energy industry for 15 years including advising clients on petroleum mining activities in New Zealand. Geof is a member of the National Tax Committee of the Institute of Chartered Accountants of New Zealand, a committee which interacts regularly with Government on tax policy developments.

SPENCER SMITH is a tax principal with Ernst & Young Ltd with particular experience in advising foreign-owned companies operating in the various resource sectors (electricity, oil & gas, gold, fishing and meat processing). He has been actively involved as an advocate for the mining industry when the current royalty regime was developed and has recently need involved with preliminary policy development on the proposed carbon tax regime.