Finding a balance

General Features

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Claire Angell and *Amy Hunt* consider the oil tax regime

Key Points

What is the issue?

Since 1975 the UK has applied a different tax regime to the taxation of profits from UK oil production.

What does it mean to me?

While the oil industry has always suffered a high rate of taxation, the specific regime that applies to UK oil companies has allowed governments to react to changes in economic reality that applies specifically to the oil industry.

What can I take away?

An understanding of the challenges of finding a balance between encouraging investment and ensuring a fair return for the UK.

Petroleum Revenue Tax and the Ring Fence: a new approach to taxation

Following the first significant discoveries being made in the UK North Sea in the early 1970s, Petroleum Revenue Tax ('PRT') was introduced to ensure a reasonable share of oil profits from the North Sea be paid in higher taxes than other sectors. There are a number of conceptual differences when compared to usual corporation tax principles:

- Rather than being levied at a company level, PRT applies on an oil field by oil field basis with the offsetting of losses on one oil field against the profits of another being allowed in only very limited circumstances;
- PRT profits are calculated on a cash receipts and actual expenditure basis, rather than the accounting profit or loss, thus the revenue and capital expenditure is less relevant than for Corporation Tax ('CT'). Initially the rate of PRT was 75% on the assessable profits;
- There were also a number of mechanisms introduced so that smaller or less profitable fields would not pay PRT at all or be subject to a lower amount of PRT.

The Oil Taxation Act 1975 also introduced the concept of the ring fence for CT purposes, which prevents the dilution of profits derived from UK oil reserves. The ring fence operates to prevent the use of non ring fence losses (i.e. from non-UK oil production activities) against oil profits. Losses from oil activities may be used to offset non ring fence profits.

PRT was deductible (or taxable if in a refund position) when calculating taxable profits for CT purposes, resulting in a marginal rate of tax for North Sea oil producers when PRT was introduced at 88% (North Sea Oil Taxation).

Reducing oil prices

Responding to the falling oil price, the smaller size of new field discoveries and decreasing investment in existing oil fields in the late 1980s and early 1990s, the Government looked to reform what Norman Lamont, then Chancellor of the Exchequer, described as the 'anachronistic' taxation of the basin.

Finance Act 1993 abolished PRT entirely for new fields. At the same time, the PRT rate for taxable fields was reduced from 75% to 50%. The Chancellor stated that this would increase tax revenues as the current PRT regime was disincentivising investment.

Some shocks…

Following the strengthening of the oil price, the Supplementary Charge to Corporation Tax ('SCT') was introduced in 2002 with the following statement 'the Government is committed to maintaining an active UK oil and gas industry and to promoting future development of the nation's oil and gas reserves. However, the North Sea fiscal regime currently fails to strike the right balance between promoting investment and taking a fair share of revenue derived from a national resource, and is therefore in need of reform.'

This additional tax is applied to Profits Chargeable to CT, although deductions for finance costs are not permitted. SCT was introduced at a rate of 10%.

From 2007 onwards, successive Chancellors reduced the main rate of CT from 30% although these reductions were not extended to the ring fence CT rate. SCT however was subject to a number of increases: 20% from 1 January 2006 and then 32% – an overnight rate increase applicable from the day after Budget Day in March 2011. This applied a marginal tax rate of 62% and 81% on older fields subject to PRT.

Some assistance

Whilst tax rates were increasing, the Government provided incentives which sought to encourage investment in the UK oil and gas sector.

SCT was introduced alongside a 100% first year allowance for wholly ring fence capital expenditure incurred on plant and machinery and mineral extraction and access. This up-front allowance aligned tax relief with the significant capital expenditure incurred in the oil and gas sector and helped those continuing to invest in the North Sea.

From 2009 field allowances were introduced, to provide a targeted incentive for the development of certain fields that were considered economically marginal. The quantum of the allowance depended on the physical characteristics of the oil field and was available to reduce profits chargeable to SCT.

The allowances were calculated on an asset by asset basis but available against a company's SCT profits as the oil field started producing oil.

To provide greater consistency and simplicity, from 1 April 2015, a new basin-wide Investment Allowance was introduced. This replaced what had become a range of allowances and broadly gives SCT relief for capital expenditure and thus seeks to encourage investment and help companies that are continuing to invest in the basin.

Taxation for maximising economic recovery

On 24 February 2014 Sir Ian Wood published a report looking at the future of the oil and gas industry in the UK. This paper put forward recommendations aimed at pursuing a strategy of maximising the economic recovery of the UK's oil reserves. Whilst the tax regime was not within the remit of the paper, it was clear that if the aim was to maximise economic recovery there would be a need for fiscal stability, consistent with the challenges of maturity. This led to HM Treasury's wide-ranging review of the fiscal regime for oil and gas companies which was published in December 2014.

Shortly after the consultations were launched on fiscal reform, the decline in oil prices from over $100 a barrel to less than $40 had a profound effect on the UK oil and gas sector. Over subsequent Autumn Statements and Budgets, a series of measures were introduced, designed to better align the tax regime to the new economics of UK oil production. These measures included reductions in the SCT rate to 10% from 1 January 2016. The rate of PRT was permanently reduced to 0% from 1 January 2016. It remains in place in order to allow for the carry back of losses against prior periods' assessable profits.

The decommissioning challenge

It is a condition of all UK oil licences that the oil companies must decommission oil production facilities. The high level of costs that result after revenues have ceased is a feature of oil production. This was recognised in the oil tax regime by allowing companies to carry back to April 2002 losses arising from decommissioning expenditure against taxable profits on a last in first out basis. From 2011, when the SCT rate was increased, a cap was introduced to the rate of relief 50% (although the headline tax rate was 62%).

The fiscal instability and flexibility of the oil tax regime created uncertainty about the tax relief which would be available for decommissioning expenditure. Many oil companies feared that when decommissioning was required the rules may change to prevent effective tax relief.

Such moving of the goal posts was recognised. The Government noted that it 'recognises that a perceived lack of certainty over how much decommissioning tax relief companies may be able to claim in future is currently making it difficult for oil and gas assets to change hands, limiting the funds available for new ventures, and deterring incremental investment'.

Decommissioning relief deeds ('DRDs') were introduced in 2013 to provide greater certainty over the future tax relief available. The DRDs are a contract signed between a company and HM Treasury. A contractual approach (rather than a legislative one) was required in order to allow for the binding of future Governments. A company can claim under a DRD in certain specified circumstances for a payment equal to the difference between the amount of tax relief received in respect of decommissioning expenditure incurred and the amount it would have achieved under the rules as they stood in 2011. The DRDs also guaranteed effective tax relief in circumstances where decommissioning costs were imposed due to a corporate failure. This had the effect of reducing security that needed to be posted and reduced the costs for many.

DRDs are a truly innovative approach to a complex problem. The answer only came with extensive collaboration between HM Treasury, HMRC and the oil industry.

Old assets, new hands

In 2017 HM Treasury published a consultation on the taxation of late life assets: 'These assets could continue to produce oil and gas for years to come, but, without further investment, could reach the end of their productive lives and be decommissioned sooner. Encouraging investment in strategically important assets is in line with the government's objective of Maximising Economic Recovery from the UK's oil and gas reserves. Part of this investment could include new, innovative investors taking over older, late-life assets'.

To respond to one of the challenges faced by new entrants and their ability to obtain effective tax relief for decommissioning, HM Treasury has announced it intends to introduce transferrable tax histories ('TTHs'), which would introduce a new concept for UK tax legislation.

As mentioned above, losses arising from decommissioning expenditure can be carried back against ring fence trading profits back to April 2002. That relief is capped at the amount of tax paid by that company.

Since new entrants do not have a tax payment history against which they can carry back future losses on decommissioning, this created a fiscal barrier which prevented assets from changing hands. TTHs are designed to allow a transfer of tax payment history on the sale of the oil field.

Summary

While the oil industry has always suffered a high rate of taxation, the specific regime that applies to UK oil companies has allowed governments to react to changes in economic reality that applies specifically to the oil industry.

The UK oil industry remains a vibrant and significant contributor to UK economic activity. It is heartening that the Government, and wider industry continue to work towards ensuring the tax regime does not inhibit maximising the full economic recovery of the UK's remaining oil reserves.