Oil and gas taxation in the UK
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Contents

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Oil and gas tax guide

Tax professionals of the member firms of Deloitte Touche Tohmatsu Limited have created the Deloitte International Oil and Gas Tax Guides, an online series that provides information on tax regimes specific to the oil and gas industry. The Guides are intended to be a supplement to the Deloitte Taxation and Investment Guides, which can be found at www.deloitte.com/taxguides. For additional information regarding global oil and gas resources, please visit our website:www.deloitte.com/oilandgas

1.0 Summary

The UK has several layers of corporate and field taxation on upstream oil and gas activities. The most important taxes which apply to companies extracting oil and gas from the UK and the UK Continental Shelf ("UKCS") are

• Ring Fence Corporation Tax ("RFCT")	30%
• The Supplementary Charge ("SCT")	32%
• Petroleum Revenue Tax ("PRT")†	50%
• Value Added Tax ("VAT")	20%
• Withholding taxes:	
o Interest	20%*
o Dividends	0%
o Royalties	20%*

* Subject to reduction under double tax agreements and domestic law exemptions.

† PRT is a field-based tax but does not apply to fields with development consent after 15 March 1993. PRT is deductible as an expense for RFCT and SCT. Thus the marginal rates generally vary between 62% and 81%, though specific field allowances can reduce this towards 30% in some cases.

2.0 Corporate income tax

2.1 In general

UK resident companies are subject to corporate income tax on their worldwide taxable profits (subject to various exemptions – for example foreign branches and qualifying dividends) at 23% (expected to fall to 20% by April 2015). Taxable profits arising from "oil extraction" or the "acquisition, enjoyment or exploitation of oil rights" in the UK or UKCS are ring fenced and subject to RFCT (oil includes gas in these definitions).

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RFCT is an entity-based tax and thus there are no field-by-field restrictions. The ring fence rules are specifically applied to UK North Sea oil and gas companies in addition to the standard corporation tax rules.

SCT is also charged on the same taxable base as RFCT, but with additional adjustments to disallow finance costs (e.g. interest, costs of obtaining debt finance, forex differences on debt finance, any other financing costs under Generally Accepted Accounting Principles (GAAP), and in some instances allow for a deduction for "field allowances" (see section 3.5).

PRT (see section 4.1 below) is a field-based tax and is deductible as an expense for both RFCT and SCT.

2.2 Rates

	PRT	RFCT	SCT
April 2006 to 24 March 2011	50%	30%	20%
From 24 March 2011	50%	30%	32%

2.3 Taxable income

Revenue arising from the sale of oil and gas at an arm's length is taxable on the actual price obtained. However, there are special rules to cover non-arm's length or related party sales (see section 5).

In certain instances, 'tariff receipts' are also subject to RFCT, SCT and PRT. These represent income from certain assets which are used by other companies (e.g. pipelines).

2.4 Deductions and allowances

In calculating taxable income, general operational and administrative costs of a revenue nature are usually deductible in full as incurred against the profits of the ring fence trade. This is subject to the criteria that they are incurred wholly and exclusively for the purposes of that ring fence trade.

PRT paid is also deductible in calculating taxable profits.

Exploration and pre-trade expenditure

Relief is generally given for all exploration and appraisal expenditure, either as a trading expense or capital allowances. However, relief is generally only available once the company has commenced a trade. Tax can therefore become payable in start up years on interest generated on surplus cash as the pre-trading ring fence expenditure is not crystallised to offset this.

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The decision to develop a field triggers the commencement of trade for UK tax purposes. The date of approval of the commercial development by Department of Energy & Climate Change (DECC) is typically taken as analogous of the date of the start of trade.

Ring Fence Expenditure Supplement (RFES)

The RFES adds an annual supplement to the value of unused expenditure carried forward from one period to another to maintain the time value of exploration, appraisal and development costs. The supplement increases the value of unused expenditure carried forward from one period to the next by a compound 10% per annum from 1 January 2012 (6% per annum prior to this date). A company can claim RFES for a maximum of six years.

In addition, see section 9.4 for details of how the RFES may apply to shale gas

Capital allowances

Capital allowances (tax depreciation) rules that apply to all UK companies also apply to upstream companies.
In addition, there are some specific rules:

- first year allowances of 100% are available on qualifying expenditure incurred in the period of acquisition on plant and machinery (subject to a five year 'use' test) or mineral exploration and access. This means that in practice, most of, if not all, development capital expenditure can qualify for immediate relief;

- if 100% first year allowances on plant are not available, plant and machinery ring fence allowances are available at a rate of 25% on a reducing balance basis (rather than 18% as applies to non-ring fence activities). Similarly, expenditure on mineral exploration and access incurred on certain costs of acquiring mineral assets and related expenditure can be relieved by way of a Mineral Extraction Allowance (MEA) at the rate of 25%, although a reduced rate of 10% applies to certain items; and

- costs of oil and gas exploration and appraisal normally attract research and development allowances (RDA) which provide for a 100% write-off of the expenditure for tax purposes as incurred.

Field allowances

Field allowances were introduced in 2009 to provide an incentive for development of commercially marginal oil and gas fields. The field allowance reduces the amount of adjusted ring fence profits on which the SCT is charged. The allowance is mandatory and no claim is required.

The original field allowances are available for companies that are licensees in qualifying fields that received their first development consent on or after 22 April 2009, and apply to accounting periods ending on or after that date. Since this date a number of other field allowances have been introduced. A qualifying field is a field that on the date of development consent may be one of the following (the gross amount of the potential allowance is in brackets):

- a small field (£150m);
- an ultra heavy oil field (£800m);
- an ultra high pressure/high temperature (HP/HT) field (£800m);
- a deep water gas field (£800m);
- extra deep water field (up to £3bn;)
- shallow water gas field (£500m); and
- brownfield development (£250m for non PRT fields and £500m for PRT fields)

The allowance becomes available in the accounting period that first development authorisation occurs but is only activated when income is generated from the field. There are detailed rules on use and carry forward of field allowances, but the quickest it could be used is over 5 years.

In addition, see section 9.4 for potential shale gas pad allowances.

Decommissioning costs

Generally, tax relief is not available for decommissioning provisions made in the financial statements, but instead relief is given when the expenditure is incurred.

A specific 100% capital allowance is available for decommissioning expenditure, provided that the expenditure is incurred on the decommissioning of plant and machinery that forms part of a UK offshore installation and the expenditure is incurred on closing down all or part of an oil field.

Decommissioning of onshore fields may qualify for relief as "demolition" of plant and machinery or mineral asset at 25%.

Tax relief for decommissioning expenditure is however restricted in respect of expenditure incurred in connection with decommissioning carried out on or after 21 March 2012. The relief is restricted for SCT purposes only to 20%, meaning that effective relief is given at between 50% to 75% (per non-PRT and PRT fields).

Corporate tax losses resulting from offshore decommissioning can be carried back to be set off against profits of the trade from 17 April 2002.

See section 6.4 for details of decommissioning relief deeds (DRDs), where the Government seek to contractually guarantee the amount of tax relief available to companies operating in the North Sea on decommissioning costs. If these proposals are legislated as expected in 2013, parts of the decommissioning tax relief legislation will be amended.

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2.5 Losses

Corporation tax losses may be carried forward and offset against future profits of the same trade or set off against other profits arising in the same accounting period. Trading losses can also be carried back and set off against the total profits of the previous year or up to three previous years in case of cessation of a trade. Losses generated by offshore decommissioning expenditure or ring fence losses generated in the last 12 months of a company's trade can be carried back and offset against profits from 17 April 2002 (see section 7.4).

There are specific restrictions under both general and ring fence corporation tax regimes for the utilization of losses where a company undergoes a major change in the nature or conduct of trade within three years before or after a change in ownership.

Losses within the ring fence can be offset against non-ring fence profit, but a non-ring fence loss cannot be used against ring fence profits.

Losses can also be surrendered to other group companies as group relief on a current year basis, whilst preserving the ring fence restrictions.

Corporation tax losses may be carried forward and offset against future profits of the same trade or set off against other profits arising in the same accounting period.

2.6 Foreign entity taxation

Generally, non-UK resident companies are only within the charge to UK tax if they carry on a trade in the UK through a branch or an agency. The UK includes UK land and 12 miles off the shore.

However, profits arising from oil and gas exploration or exploitation activities in the UK or a "designated area"(i.e. UKCS) are subject to UK tax and are treated as profits of trade carried on in the UK through a branch or an agency. The "designated area" is set by the Crown and includes license interests in the North Sea beyond the 12 mile limit.

Capital gains arising on sales by non-UK residents of certain UKCS assets or shares deriving their value or the greater part of their value from UK oil and gas assets are also within the charge to UK tax. This is subject to the provisions of the relevant double taxation treaty. If certain conditions are met, the substantial shareholding exemption may also be available to exempt any gain on the sale of shares.

3.0 Other corporate income tax

3.1 Additional profits taxes

Petroleum Revenue Tax ("PRT")

PRT is a field-based tax charged on profits arising from individual oil fields. The tax only applies to fields first given development consent before 16 March 1993. PRT is charged in addition to RFCT and SCT, but is a deductible expense for both these corporation tax regimes. Currently only around 30 fields in the UKCS are PRT paying.

Profits are taxed for six month chargeable periods to 30 June and 31 December.

Gross taxable profit for PRT purposes is determined by the value of the participator's share of production from a taxable field in a chargeable period. In addition to the revenue from oil and gas sales, companies are assessed on income from tariff receipts. Tariffs from 'new' fields post 2004 are exempt from PRT.

Relief is given for most expenditure, but only after it has been claimed by the operator or participator and allowed by HM Revenue & Customs. In order for relief to be granted, expenditure must relate directly to the PRT paying field, although expenditure on searching for oil and gas is allowable if conducted within 5,000 meters of the field boundary. There is no distinction between costs of a 'capital' and costs of a 'revenue' nature for PRT purposes. No relief is available for financing costs. Since there is no financing deduction, some capital expenditure, notably that on bringing a field into production, is given a 35% supplementary allowance (uplift). Expenditure is normally incurred by the operator in respect of the whole field and allocated to companies by their field interest.

Additional relief from PRT is provided by oil allowances that reduce the effective rate of PRT for a period. The allowance is given for an entire field and subsequently allocated to each participator according to a certain formula. Oil allowance results in a number of fields that are otherwise within the scope of PRT being non-PRT paying.

A 'Safeguard' is also applied to some fields in certain circumstances to limit the PRT payable, though it is generally no longer relevant prospectively for many fields. PRT losses can be carried forward indefinitely. In addition, PRT losses can be carried back indefinitely against the assessable profits of earlier periods on a last-in-first-out basis provided that there has been no change of ownership. Excess unrelieved losses upon cessation of oil production can be relieved, subject to certain criteria, against the PRT profits of other fields of the participator or of associated companies. The loss carry back provisions are subject to special rules on a change of ownership of a field

4.0 Tax incentives

4.1 Research and development

In addition to the particular reliefs and allowances unique to the oil and gas industry set out above, UK upstream companies may also be able to benefit from R&D tax credits.

'Large' oil and gas companies can claim an additional 30% deduction on qualifying revenue R&D expenditure. For ring fence companies this represents 18.6% credit on costs. Small or medium sized companies can claim a deduction of an additional 125% or a repayable tax credit. In practice, operators are the companies most likely to benefit from this incentive.

In addition, the Government announced the introduction of an above the line ("ATL") R&D tax credit in Budget 2013. The credit will be 49% to maintain the value of the credit under the existing scheme. At present companies will have to elect into this scheme until it becomes mandatory in April 2016.

In addition to the particular reliefs and allowances unique to the oil and gas industry set out above, UK upstream companies may also be able to benefit from R&D tax credits.

5.0 Payments to related parties

5.1 Transfer pricing

All companies subject to UK tax may be required to undertake their transactions with connected parties on an arms' length basis adopting OECD guidelines.

In addition, specific rules apply to upstream companies. Ring fence activity is treated as a separate body for the purposes of the transfer pricing rules (i.e. transfer pricing rules are extended to apply to any transaction taking place within the company but across the ring fence).

Additional rules also apply to the sales of oil and gas by ring fenced companies to connected parties, which may impose a specific price for tax purposes.

5.2 Thin capitalization

The UK does not have separate thin capitalization rules, but instead applies the transfer pricing rules where the level or terms of connected party debt of a company is not on arm's length terms when considered in the light of the company's overall position.

5.3 Interest deductibility

Interest charges can only be set against ring fence profits to the extent that the interest was paid in respect of money borrowed to finance oil extraction activities or acquisition of ring fence assets. The purchase of shares of a company is not a ring fence activity. Interest is not deductible for SCT or PRT.

In addition to these specific ring fence restrictions, other UK interest restrictions that apply to all UK companies also apply. These include restrictions on interest where the debt has an unallowable purpose, involves 'arbitrage' or if the loan has unusual terms, for example quasi-equity characteristics. However, the 'worldwide debt cap' rules do not apply to ring fence financing.

6.0 Transactions

For disposals on or after 6 December 2011, a capital gain arising on disposal of ring fence assets is subject to UK tax at 62% (i.e. to RFCT and SCT).

6.1 Capital gains

For disposals on or after 6 December 2011, a capital gain arising on disposal of ring fence assets is subject to UK tax at 62% (i.e. to RFCT and SCT). Disposals of shares in UK oil companies are not treated as ring fence capital gains. However, non-residents may be taxed on a capital gain if the shares sold derive their value or the greater part of their value from UK oil and gas assets. There may be a secondary liability for the buyer to consider in these cases (see section 2.6 for more details).

6.2 Asset disposals

Asset disposals may give rise to taxable capital gains and a recapture of capital allowances (tax depreciation). The allocation of consideration in sale and purchase agreements for asset disposals is important for taxation purposes for both vendor and purchaser. This is because the allocation will determine capital allowances (tax depreciation) and capital gains tax position between buyer and seller on the transaction.

If a ring fence capital gain arises, reinvestment relief is available to exempt gains from RFCT and SCT where the proceeds of a disposal are reinvested in UK oil assets used for the ring fence trade, one year before and three years after the disposal

6.3 License swaps

Where UK North Sea licenses are swapped and no cash consideration is involved, no chargeable gain (or loss) will arise on the disposal to the extent that the value of the license acquired equals the value of the license disposed of.

6.4 Offshore decommissioning security arrangements

In Finance Act 2013 the Government introduced tax legislation to facilitate a contractual regime to provide certainty on tax relief for offshore decommissioning expenditure.

Under the regime, Government have the power to enter into deeds with companies operating in the UK North Sea to guarantee the level of tax relief that will be available for offshore decommissioning expenditure. The aim of these changes is to provide greater certainty regarding tax relief for offshore decommissioning such that security in respect of offshore decommissioning (for which there is joint and several liability between field partners) can be provided on a net (post tax) rather than gross (pre-tax) basis.

Key features of the draft deed include:

- a guaranteed payment from Government if the amount of tax relief obtained for offshore decommissioning expenditure is less than the amount due under the tax code in force at Finance Act 2013;

- guarantee of tax relief for offshore decommissioning expenditure incurred in respect of another party's liability (as a result of default) where full tax relief might otherwise have been unavailable. This is at the rate of 50% irrespective of tax capacity for CT and SCT purposes, but based on tax capacity for PRT;

- confirmation that payments obtained under the contract will not form part of taxable profits or chargeable gains of the company for corporation tax or supplementary charge purposes; and

- targeted anti-avoidance provisions to ensure that payments cannot be obtained under contract where abusive arrangements have been entered into, or where the principles of the contract have not been adhered to.

6.5 Sharing arrangements and farm outs

Farm-outs of license interests of undeveloped areas are deemed to be for nil consideration if the consideration received relates wholly to an exploration or appraisal work program or another undeveloped UK block. To the extent that cash or other consideration is received, this may be taxable.

Capital gains from other forms of farm outs may be subject to RFCT and SCT.

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7.0 Withholding taxes

7.1 Dividends

There is no withholding tax levied on dividend payments made by a UK tax resident company.

7.2 Interest

Withholding tax of 20% is applied to annual interest payments, subject to certain exemptions and relief under double taxation treaties.

7.3 Rents and royalties

Withholding tax of 20% is applied to certain types of royalty payments, subject to relief under double taxation treaties.

Certain tax treaties may also mitigate some elements of UK upstream tax rules (for example on capital gains and offshore contractors).

7.4 Tax treaties

The UK has a very extensive network of double tax treaties with other jurisdictions, allowing for a reduction in withholding tax rates in many cases.

8.0 Indirect taxes

8.1 Value added tax, goods and services tax, and sales and use tax

The standard rate of VAT in the UK is 20%, with certain products eligible for reduced rates of 5% (including supplies of domestic fuel or power) or 0% (including most supplies of goods moved out of the UK).

Oil and gas companies are able to register for UK VAT at the outset of an exploration and production phase and recover VAT they incur on expenses (including capital expenditure). It is the practice of HM Revenue & Customs not to claw back any VAT repaid to the business if exploration is unsuccessful and no taxable supplies are made.

To speed up the reimbursement of VAT costs, companies can elect to submit monthly rather than quarterly VAT returns. VAT law states that in order to recover input tax, the taxpayer must hold a valid VAT invoice.

Oil and gas are regarded as ‘goods’ for indirect tax purposes, although special rules apply to gas moved in distribution networks or imported in a vessel.

8.2 Import, export, and customs duties

Customs duty (rates depending on product classification) and VAT (at 20%) are usually due on imports of goods into the UK from outside of the EU. However, goods subject to excise duty (such as crude oil and refined oil) may be placed in a tax warehouse (an approved storage facility or refiner's premises). This suspends payment of import VAT and duty until the goods are removed.

Sales of goods whilst they are warehoused are generally treated as outside the UK and therefore outside the scope of UK VAT. This can alleviate UK VAT registration obligations for non-UK traders. If oil is fully refined in a tax warehouse, the goods are regarded as new UK produced goods and import VAT is no longer due. Rather, the last supply before removal of goods from the warehouse is generally subject to UK VAT. Apart from certain exceptions for Liquefied Petroleum Gas, natural gas products are not excisable in the UK thus cannot be entered into an excise warehouse. There are special rules exempting imported natural gas from being liable to import VAT on entry into the UK.

Customs duty (rates depending on product classification) and VAT (at 20%) are usually due on imports of goods into the UK from outside of the EU.

8.3 Excise tax

The rate of excise duty applied to oil and gas products is determined by the classification of the product. In addition, products stored in an excise warehouse are afforded duty suspension, but become subject to the excise duty once removed for domestic use.

8.4 Stamp tax

The purchase of land and assets connected to the land is subject to stamp duty land tax at 4% (for commercial property) of the asset value, normally payable by the purchaser. The sale of shares of a UK company is subject to UK Stamp Duty at a rate of 0.5%, again payable by the purchaser.

Stamp taxes to do not apply to licenses situated in territorial waters. However, offshore structures that are connected to the land may fall within the scope of stamp tax.

9.0 Other

9.1 Choice of business entity

Companies that are resident in the UK for tax purposes (either by incorporation in the UK or by their central management and control being situated in the UK) and UK branches of non-UK companies are subject to RFCT and SCT where they carry on a UK ring fence trade.

All license grants must be approved by the UK government who generally require a UK place of business. Whilst UK oil and gas licenses can be owned by non-UK companies, it is common for them to be owned by UK companies.

9.2 Foreign currency

The taxable profits of a company are calculated in the functional currency of the company with tax being payable in Pounds Sterling. However, all capital gains for UK companies are calculated in Pounds Sterling.

9.3 Offshore contractors and subcontractors

Offshore contractors and subcontractors who carry on activities on the UK Continental Shelf in connection with UKCS upstream activities may be subject to UK tax, giving rise to certain reporting and withholding requirements for upstream companies using contractors and subcontractors.

9.4 Shale gas

Shale gas is still very much in its infancy in the UK. However, in Budget 2013 Government announced incentives to encourage the development of shale gas in the UK these incentives could take the form of a new shale allowance and an extension of the current RFES. Further detail on the proposed incentives was provided in the consultation document ("ConDoc") released on 19 July 2013.

As outlined in the ConDoc, conventional hydrocarbons are generally found in discrete fields. However, unconventional hydrocarbons i.e. shale can cover large areas which cannot be easily defined. As such, the ConDoc proposes a shale gas allowance similar to the existing allowance would not be appropriate. Rather, a 'pad' allowance is proposed.

Government announced incentives to encourage the development of shale gas in the UK these incentives could take the form of a new shale allowance and an extension of the current RFES.

The pad allowance would work as existing allowances (e.g. small field allowances, brown field allowances) by exempting a portion of the profits from the shale gas production from the SCT, reducing the effective tax rate on these profits towards 30%.

The amount of the profits that would be sheltered from the SCT would be a proportion of the capital expenditure incurred in relation to the pad. For the purposes of the pad allowance, capital expenditure would be limited to the expenditure that would attract 100% first year allowances. The allowance would become available as soon capital expenditure was incurred on a pad. Costs incurred prior to the effective date of the introduction of the pad allowance would not contribute to the generation of the allowance.

As with the existing allowances, it is proposed that the amount of the allowance that can be utilised will be restricted to the lower of the production income from the pad or potentially a fifth of the allowance (i.e. the quickest the allowance could be used would be five years). However, unlike existing allowances, the percentage interest in the pad would not give rise to an equivalent interest in the pad allowance as only the participator that actually incurs the expenditure will be entitled to the allowance.

In addition to the pad allowance, the ConDoc also proposes that the existing RFES be extended to ten years for shale gas projects (as opposed to six years for conventional projects). The purpose of this is to recognise the longer payback periods for shale projects. The ConDoc proposes that after six years the losses from shale projects are split from the losses arising on conventional projects and the shale losses can then still be uplifted for a further four years.

These proposals are still in development with the consultation period closing in autumn 2013 and we would expect further details to be provided in the 2013 Autumn Statement before implementation in Finance Bill 2014.

10.0 Oil and gas contact information

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Designed and produced by The Creative Studio at Deloitte, London. 31176A