Oil and gas taxation in The Falkland Islands

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1.0 Summary

The principal taxes and rates applicable to companies involved in upstream oil and gas extraction in the Falkland Islands or Falkland Islands designated area are:

• Corporate Income Tax	26%
• Petroleum Royalty	9%
• Withholding taxes:	
– Interest	10%*
– Dividends	0%
– Royalties	10%*

* Subject to reduction for certain excluded territories or under double tax agreements.

The Falkland Islands does not operate a Production Sharing Contract ("PSC") system.

The Falkland Islands are a self-governing British overseas territory. Parts of the Falkland Islands tax legislation have been based on UK legislation, and thus persons familiar with the UK tax system may notice certain similarities. However it should be noted that the tax systems are legally separate, and in some cases have major differences. The Falkland Islands Government Tax Office (FIGTO) therefore encourages persons not to rely on UK experience without first referring to the relevant Falkland Island's legislation.

This guide has been prepared based on the prevailing tax legislation at the time of writing. However, we would note that the Falkland Islands government is currently undertaking a tax legislation re-write, and thus we would encourage users to check for relevant updates that may have been introduced after the date of this guide.

2.0 Corporate income tax

2.1 In general

Falkland Islands resident companies are subject to corporate income tax on their worldwide income and gains. Non-resident companies that derive income from Falkland Islands sources are also subject to tax on that income.

Taxable profits arising from "petroleum extraction activities" or the "acquisition, enjoyment or exploitation of petroleum rights" in the Falkland Islands and the Falkland Islands Continental Shelf ("Designated Area") are ring fenced from other profits or losses. The Designated Area was defined in the Falkland Islands (Continental Shelf) Proclamation 1991.

2.2 Rates

Corporate Income Tax is imposed at a rate of 26%. A lower rate of 21% may apply for any non-ring fence income of less than £1.0 million in a 12 month period, however all ring fence income is taxed at the full rate of 26%.

2.3 Taxable income

Revenue arising from the sale of oil and gas at arm's length is taxable on the actual price obtained and will be taxable within the ring-fence. However, there are special rules to cover non-arm's length or related party sales (see section 4).

Certain tariff receipts arising from assets (e.g. pipelines) used in ring-fence trades may also be taxable within the ring-fence. Gains from sale of petroleum-related assets that are capital in nature are also included in assessable ring-fence income (see section 5.1).

2.4 Deductions and allowances

General deductions

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.

Petroleum royalties (see section 6.0) are also permitted as a deduction in calculating ring-fence profits.

Exploration and pre-trade expenditure

Relief is generally given for all exploration and appraisal expenditure, either as a trading expense or depreciation allowances. However, relief is generally only available once the company has commenced a ring-fence trade.

In practice, it is accepted that the point at which a decision is made to proceed with commercial development of a field triggers the commencement of a ring-fence trade for Falkland Islands tax purposes. The date of approval of the commercial development by the Department of Mineral Resources is typically taken as analogous of the date of the start of such a trade.

Depreciation allowances

Depreciation allowance (tax depreciation) rules for companies involved in upstream petroleum activities are distinct from those applying to other activities. Allowances are available for capital expenditure as follows:

- 100% allowance for exploration and appraisal costs
- 100% allowance for intangible drilling costs
- 25% annual writing down allowance for plant and machinery costs (other than costs falling to be exploration and appraisal costs as above)

Where capital expenditure is incurred prior to the commencement of a ring-fence trade, such expenditure is deemed incurred on the day the ring-fence trade commences.

Demolition and abandonment costs

the demolition or abandonment of used for a ring-fence trade Abandonment expenditure would include any amount incurred:

- for the purpose or in connection with the closing down of all or part of a ring fence trade;
- on demolition or abandonment of plant and machinery used in a ring fence trade and which forms part of an offshore installation or pipeline; and
- on demolition or abandonment carried out in order to comply with an abandonment program.

Generally, such relief is not available for demolition and abandonment provisions made in the financial statements, but instead relief is given when the expenditure is actually incurred.

Relief is restricted to expenditure incurred within the period of three years following the last day that the ring fence trade was carried on. Under current legislation, the expenditure is treated as incurred during the last period of trade and allowance will be available as a 100% deduction.

Expenditure incurred in the last period of trade may be carried back against ring-fenced profits of the previous three periods.

Interest

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. Interest incurred in respect of money borrowed to acquire petroleum rights is not permitted as a deduction.

2.5 Losses

Ring-fence tax losses may be carried forward and offset against future profits of the ring-fence trade. There is no time limit on the carry forward of such losses.

Ring-fence losses may also be carried back and set off against the ring-fence profits of the previous year. Ring-fence losses generated by offshore demolition or abandonment expenditure, or losses generated in the last period of a company’s ring-fence trade may be carried back and offset against ring-fence profits of the previous three periods.

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

2.6 Foreign entity taxation

Generally, non-Falkland Islands resident companies are only subject to Falkland Islands tax if they carry on a trade in the Falkland Islands and designated area through a permanent establishment.

However, profits arising from oil and gas exploration or exploitation activities in the Falkland Islands or the Designated Area are subject to Falkland Islands tax and are treated as profits of a trade carried on in the Falkland Islands through a branch.

Capital gains arising on sales by non-Falkland Islands residents of certain Falkland Islands oil and gas assets, or shares deriving their value or the greater part of their value from Falkland Island oil and gas assets, are also subject to Falkland Islands tax. This is according to the provisions of the relevant double taxation treaty.

3.0 Tax incentives

3.1 Depreciation allowances

The principle tax incentives unique to the oil and gas industry are the availability of 100% depreciation allowances for exploration and appraisal and intangible drilling costs, as set out in section 2.4 above.

4.0 Payments to related parties

4.1 Transfer pricing

All companies subject to Falkland Islands tax are required to undertake transactions with connected parties on an arm's length basis.

In addition, specific rules apply to upstream companies. Ring fence activity is treated as a separate body for the purposes of 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, whereby actual sales price will be substituted for market value where the sale is not considered to be on an arm's length basis.

4.2 Thin capitalization

The Falkland Islands do not have separate thin capitalization rules, but instead apply 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.

4.3 Interest deductibility

In addition to general restrictions on deductibility of interest on connected part debt that is not on an arm's length basis, special rules apply to connected party debt issued by ring-fence companies. In such cases, interest may not be permitted as a deduction unless the Commissioner of Taxation directs that the payment may be deducted.

5.0 Transactions

5.1 Capital gains

A capital gain arising on disposal of ring fence assets or of unquoted shares in companies deriving their value directly or indirectly from exploitation or exploration rights will be subject to Falkland Islands tax at 26%.

Disposals of shares in Falkland Islands oil companies will be treated as ring fence capital gains and non-residents may be taxed on a capital gain if the shares sold derive their value, or the greater part of their value, from Falkland Islands oil and gas assets. There may be a secondary liability for the buyer to consider in these cases.

5.2 Asset disposals

Asset disposals may give rise to taxable capital gains and a recapture of tax depreciation allowances. 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 the tax depreciation allowances and capital gains tax position between buyer and seller on the transaction, as their claw back provisions and restrictions on depreciation allowances available after the disposal.

5.3 License swaps

Where petroleum licenses are swapped between unconnected parties 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.

5.4 Sharing arrangements and farm outs

Farm-outs of license interests of undeveloped areas are deemed to be for nil consideration if the consideration received consists of another licence or interest in another licence, or an obligation to undertake an exploration or appraisal work program in the licence area disposed of. To the extent that cash or other consideration is received, this may be taxable.

These provisions do not apply to disposals of developed licence areas.

Where non-cash consideration is received, it may be possible for any resulting tax to payments to be deferred, subject to approval.

5.5 Disposals before ring-fence trade commenced

Where a company disposes of an interest in a petroleum licence before it has commenced a ring fence trade, any pre-trading exploration and appraisal or intangible drilling expenditure incurred by the seller that would have qualified for depreciation allowances will transfer to the buyer. However, the amounts transferred will be restricted where the consideration given by the buyer is less than the original expenditure incurred by the seller.

6.0 Royalties

6.1 Petroleum royalties

Royalties are payable at 9% of the market value of petroleum won and saved. Royalties are a deductible cost in calculating ring-fence profits for corporation tax purposes.

7.0 Withholding taxes

7.1 Dividends

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

7.2 Interest

Withholding tax of 10% may be applied to annual interest payments made by a resident in the Falkland Islands to a non-resident payee. However, withholding tax will not apply where the payee is tax resident in a country included on a specified list of countries which are not low tax territories.

7.3 Royalties

Withholding tax of 10% is applied to certain types of royalty payments made by a resident in the Falkland Islands to a non-resident.

Rental payments made for equipment used outside the 12 nautical miles of the Falkland Islands shoreline are not subject to royalty withholding tax.

7.4 Tax treaties

The Falkland Islands currently has only one double tax treaty in force, with the UK. This allows for the elimination of withholding taxes on interest and royalties in certain cases.

8.0 Indirect taxes

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

There is currently no VAT regime in the Falkland Islands.

8.2 Stamp tax

Stamp taxes are currently not applied in the Falkland Islands.

9.0 Other

9.1 Choice of business entity

Various structures can be adopted for an investment in a Falkland Islands oil and gas project. The issues can be complex and will depend on the particular facts and circumstances of the investor and the project.

Companies that are resident in the Falkland Islands for tax purposes and Falkland Islands Branches of non- Falkland Islands companies are subject to Falkland Islands Corporate Tax where they carry on a Falklands Islands trade. Most inbound companies tend to invest via a Falkland Islands branch. The subsequent conversion of a branch into an incorporated Falkland Islands structure can have significant ramifications, so this decision needs to be carefully considered at the outset.

9.2 Tax administration

All companies carrying out activities in the Falkland Islands are required to register for corporation tax with the Falkland Islands Government Tax Office (FIGTO) when they first commence trading. Generally, corporation tax is payable 8 months and 1 day after the end of the tax accounting period.

9.3 Foreign currency

Generally, the accounting records and taxable profits of a company should be in Pounds Sterling. However, a company that is carrying on ring-fence trade can elect to keep its accounting records and account for tax in US dollars. The election must be made in writing and is irrevocable.

9.4 Offshore contractors and subcontractors

Offshore contractors and subcontractors who carry on activities in the Falkland Islands and Designated Area are subject to Falkland Islands tax, giving rise to certain reporting and withholding requirements for upstream companies using contractors and subcontractors.

Under the UK-Falkland Islands Tax Treaty, there is a de-minimis time rule available for UK resident companies that carry out activities in the Falkland Islands controlled waters in connection with exploration activities for a period, or periods, not exceeding in aggregate 30 days in any 12 month period. In such cases, any profits from those activities will not be taxable in the Falkland Islands.

10.0 Oil and gas contact information

London (GMT)

Deloitte LLP
2 New Street Square
London EC4A 3BZ
United Kingdom

Julian Small
Tax Partner, UK Head of Energy & Resources
Telephone: +44 (0) 20 7007 1853
Email: jsmall@deloitte.co.uk

Roman Webber
Tax Partner, UK Head of Oil & Gas Tax
London
Telephone: +44 (0) 20 7007 1806
Email: rwebber@deloitte.co.uk

James Bamford
Senior Manager, Energy & Resources Tax
London
Telephone: +44 (0) 20 7007 0616
Email: jbamford@deloitte.co.uk

Aberdeen (GMT)

Deloitte LLP
Union Plaza
1 Union Wynd
Aberdeen AB10 1SL

Derek Henderson
Tax Partner, Managing Partner
Aberdeen
Telephone: +44 1224 84 7344
Email: dehenderson@deloitte.co.uk

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