Global oil & gas tax newsletter
Views from around the world

In this issue

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Spotlight on the UK: New R&D and intellectual property regimes

Introduction

The UK government has expressed its commitment to making the UK a competitive place to do business. Various tax incentives have been put in place to help companies, whether multinationals or Small and Medium Size Enterprises ("SMEs"), to innovate and grow. Two such incentives took effect on 1 April 2013: the Above the Line ("ATL") Research and Development ("R&D") credit and the Patent Box regime.

The changes to the R&D scheme are designed to increase the visibility and certainty of the R&D relief and provide greater support to companies with no corporation tax liability. Many energy companies incorrectly believe that they are not undertaking any R&D (or are unaware that what they might consider routine activities are eligible as R&D for tax purposes). The definition of an eligible project is widely drawn and experience shows that upstream and oil field services businesses generally have much more eligibility than they think. We often find that most businesses are able to readily identify R&D associated with joint industry projects but miss the R&D embedded in the day-to-day activities of the exploration, development, and asset teams.

It is expected that there will be a new set of claimants within the industry as more exploration-based businesses with headcount in the UK and large losses will benefit from the new ATL R&D regime.

In summary, the new credit is paid at a headline rate of 10 percent for non-ring-fenced (i.e., outside of ring fence or "ORF") and 49 percent for ring-fenced qualifying R&D expenditure, and it is fully refundable net of tax to companies with no corporation tax liability. Large companies (and SMEs claiming under the large company scheme) can benefit from this new credit. Being similar in nature to a grant, the relief may be accounted for "above the line" within operating profit, making it a more visible form of relief than the existing super-deduction scheme and a better incentive to those that make R&D investment decisions. In other words, it positively impacts EBIT and translates into cash.

The ATL credit is available for expenditure incurred on or after 1 April 2013 but up until April 2016 companies can make an irrevocable election into the ATL regime or remain under the existing super-deduction regime.

Many energy companies incorrectly believe that they are not undertaking any R&D (or are unaware that what they might consider routine activities are eligible as R&D for tax purposes).

The Patent Box is another beneficial incentive which allows profits from patented products, processes or services to be taxed at 10 percent rather than at the standard corporation tax rate. The incentive should be of significant value to the downstream and oil field services industries but the regime is not available for ring-fenced activities.

We typically find that … between 5 and 15 percent of total staff costs (across the company) qualify for R&D.

R&D in the industry

Upstream

In response to global demands, upstream businesses are spending more on exploration and production ("E&P"). Much of this is focused on developing technologies to find new reserves and on enhancing production efficiencies from existing fields. Furthermore, increasing environmental and safety requirements have led to many businesses developing new or appreciably improved production technologies.

Many costs associated with exploratory and appraisal work can be capitalized. However, in our experience, often project costs in relation to subsurface, exploration, development and production activities are incurred prior to the capitalization point and may be eligible for R&D incentives. Whether a company claims R&D tax relief (the "super-deduction") or the new ATL credit, the benefit of making claims inside the ring fence ("IRF") can be up to 18.6 percent of the qualifying expenditure.

Our experience in preparing a wide range of claims in the upstream sector suggests that many upstream businesses are still unaware of the extent to which their activities are eligible for R&D incentives. We typically find that (notwithstanding the level of capitalization), between 5 and 15 percent of total staff costs (across the company) qualify for R&D. We have also found that claims are not limited to research centers, as eligibility oftentimes extends into day-to-day operations.

Key areas where eligibility can be found include:

Exploration and reservoir modeling

Major scientific or technological challenges must be overcome to accurately interpret reservoir volumes and under-utilized reserves in a mature basin such as the North Sea, however, experience shows that many companies overlook the possibility that this work will be eligible for R&D tax relief purposes. Eligibility may be found in the design of seismic data acquisition using newer technologies, work to enhance seismic processing and interpretation workflows, and reservoir model re-build projects where the field is causing challenges that cannot be readily solved using simulation software.

Subsurface and drilling

Drilling, completion and subsea developments are also becoming increasingly technologically challenging. Many new discoveries are too small to develop with a separate production platform, contain challenging fluids which are highly corrosive or low viscosity and produce fluids at high pressures and temperatures. These technological challenges are driving innovative drilling and subsea technology developments. Our experience is that many of these technology developments are overlooked when making an R&D tax relief claim, and asset owners are not making full use of the R&D capital allowances for prototype or trial equipment developed for R&D purposes.

Our experience is that many of these technology developments are overlooked when making an R&D tax relief claim … .

Production developments

Once a field is in production, technology developments will continue throughout its lifetime. Many operator activities will be routine in nature but our experience is that most operators face challenging well performance or flow assurance issues that are unusual and cannot be readily resolved using standard approaches. In this context, the development of new treatments, enhanced oil recovery projects or mitigation processes can be eligible for R&D tax relief. In addition, increasingly stringent environmental legislation is forcing operators to develop technologies to reduce the impact of their production facilities. Many of these developments involve substantial eligible revenue expenditure, even within an upstream business. A range of activities from design through to testing of prototype equipment or processes may be eligible for the relief, and consumable or transformable materials employed in trials and testing should also be considered in any claim.

Oil field services

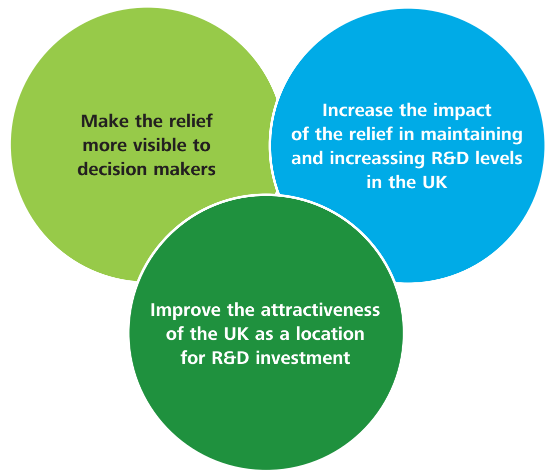
Below is a list of some of the qualifying activities that are often identified within the oil field services sector where we tend to see 20 to 40 percent of total staff costs of the company qualifying for R&D:

- Development of improved installation or construction techniques (e.g., pipe laying in very deep or shallow waters)
- Development of tools that withstand higher pressures, temperatures, or more corrosive fluids (e.g., HPHT, H_2S, etc.)
- Development of innovative inspection, repair or maintenance technologies (e.g., intelligent pigging)
- Development of large scale, complex offshore production facilities and subsea infrastructures in remote locations.

… a taxable credit was recently introduced for qualifying R&D expenditure incurred on or after 1 April 2013.

Policy objectives of the ATL R&D credit

As stated above, a taxable credit was recently introduced for qualifying R&D expenditure incurred on or after 1 April 2013. The basis for the introduction of this new relief is set out below.



Key takeaways

- A taxable credit, paid at a headline rate of 10 percent or 49 percent (calculated by reference to qualifying expenditure).
- Fully payable, net of tax, to companies with no corporation tax liability.
- Was introduced alongside the existing super-deduction in April 2013, and will replace the super-deduction in April 2016 (optional during transition period, although once a claimant elects into ATL, the election is irrevocable).
- Available to surrender to group companies.
- Safeguarded from abuse through the introduction of a Pay As You Earn ("PAYE")/National Insurance Contribution ("NIC") cap on the payment of the credit to companies with no corporation tax liability. The PAYE/NIC cap is likely to impact companies where the non R&D staffing costs (e.g., Externally Provided Workers ("EPWs") / consumables) in claims filed are approximately three times the R&D staffing costs element.

How does it work?

	Current Super-deduction Scheme (ORF) £M	ATL Credit (ORF) £M	Current Super-deduction Scheme (IRF) £M	ATL Credit (IRF) £M
Revenue	1,500	1,500	1,500	1,500
Costs – general	(800)	(800)	(800)	(800)
Costs – qualifying R&D	(200)	(200)	(200)	(200)
ATL R&D expenditure credit @10% (or 49%)	–	20	–	98
Profit before tax	500	520	500	598
Tax charge before R&D credit effect @ 23% (or 62%)	(115)	(119.6)	(310)	(310)
Effect of R&D tax credit (Super-deduction) (30% x 23%=6.9%) (or 30% x 62% =18.6%)	13.8	–	37.2	–
Tax on ATL credit @23% (or 62%)	–	(4.6)	–	(60.8)
Tax charge	(101.2)	(124.2)	(272.8)	(370.8)
Profit after tax	398.8	395.8	227.2	227.2
Effective tax rate	20%	24%	55%	62%

*Note that the ATL credit would be applied to discharge the amount of tax payable.

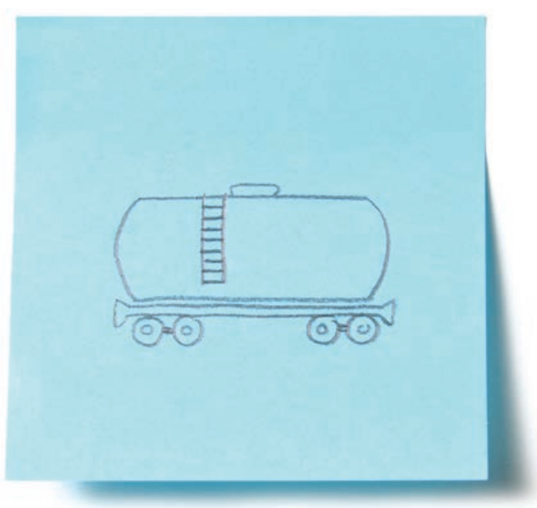
Effective benefit for large companies

		Effective Benefit		
Accounting Period	Tax Rate	Super-Deduction Regime	ATL Regime	Ring-fenced Activities ATL and Super-deduction Regimes
April 2013	23%	6.9%	7.7%	
April 2014	21%	6.3%	7.9%	18.6%
April 2015	20%	6.0%	8.0%	

The effective benefit for the super-deduction is calculated by multiplying the R&D uplift (30 percent) by the corporate tax rate (e.g., 30 percent x 23 percent = 6.9 percent). The effective benefit for the ATL regime is calculated by taking the net of the ATL credit rate and the corporation tax rate (e.g., 10 percent * (100 percent – 23 percent) = 7.7 percent for ORF or 49 percent * (100 percent – 62 percent) = 18.6 percent for IRF).

For qualifying IRF expenditure, the date of electing into the ATL regime may not be as important as the benefit levels are the same under the ATL and super-deduction regimes. For ORF-defined qualifying expenditure, the ATL benefit is more beneficial compared to the super-deduction as the UK corporation tax decreases.

Companies with service company arrangements will need to consider which entities are claiming the R&D and whether the activities will be ORF or IRF as these factors will have a significant impact on the R&D regime to adopt and when to adopt it.



However, unlike the existing super-deduction scheme, companies with no (or insufficient) tax liability will be able to receive their credit, net of tax, in cash.

Payment mechanism

Companies with sufficient tax liability will be able to receive their ATL R&D credit by offsetting it against their tax liability. However, unlike the existing super-deduction scheme, companies with no (or insufficient) tax liability will be able to receive their credit, net of tax, in cash. This cash payment is subject to certain restrictions and criteria, and there is a seven step process that companies in this situation need to follow in order to determine how to receive their credit. Some of the key points are set out below:

- The cash portion of the credit is restricted to the sum of:
  - The total PAYE/NIC liabilities in respect of the employees whose staffing costs are included in the claim and
  - The PAYE/NIC liabilities of employees provided by a fellow group company but restricted to the appropriate proportions, i.e., effectively their average R&D eligibility.
- Any excess credit so restricted, however, is not lost but carried forward to the next accounting period.

- Following application of the PAYE/NIC restriction, a company can offset its credit against tax liabilities of any period and against tax liabilities of another group company for the same period.

- Payable credit will not be paid if the company is not a going concern or it has outstanding PAYE/NIC liabilities.

- Credit may be withheld if there are enquiries into the company's tax return, although HMRC has the discretion to make provisional payments in this circumstance.

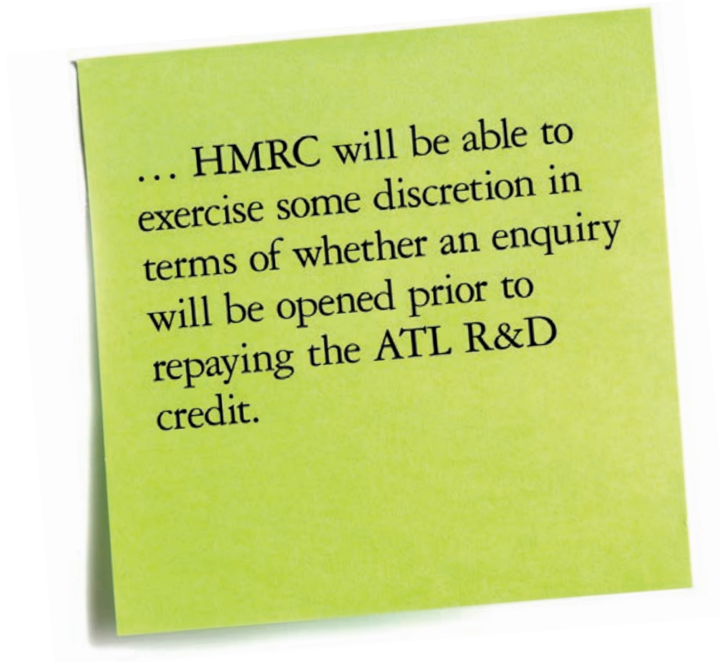
The PAYE/NIC restriction will only affect those companies not able to offset the credit against their current period corporation tax liability. For those companies which are not tax paying and are seeking to receive the tax credit, it should be noted that there are currently no details available in respect of how long after the submission of the R&D claim that the credit will be received. In addition, the credit will not be repayable unless it is submitted with, or as an amendment to, a tax computation and return plus a signed set of financial statements. Furthermore, HMRC will be able to exercise some discretion in terms of whether an enquiry will be opened prior to repaying the ATL R&D credit.

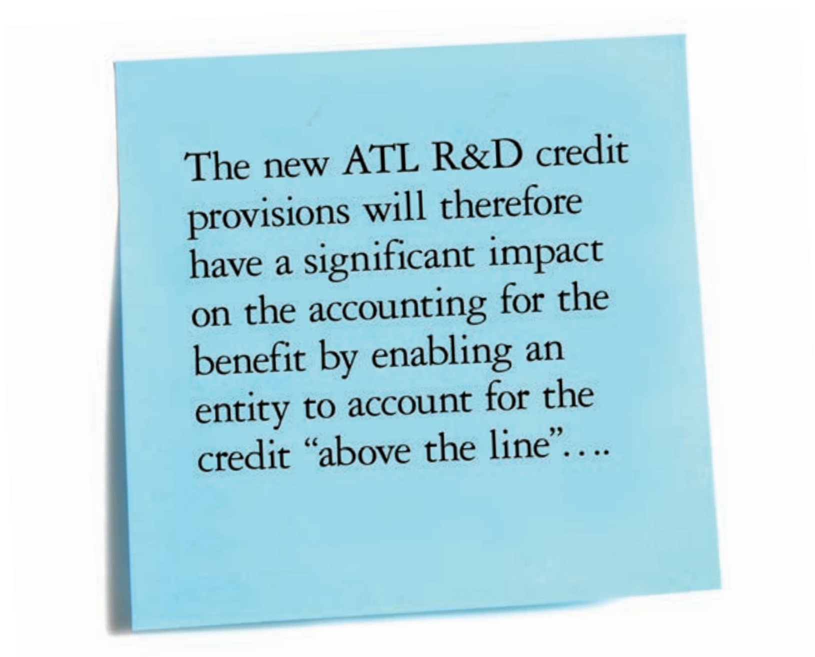
Accounting for the credit

It was the explicit aim of the government to design the new scheme such that it had the attributes of a "grant" so it could be accounted for "above the line" rather than as part of income tax expense, to further incentivize innovative investment by large companies.

The new ATL R&D credit provisions will therefore have a significant impact on the accounting for the benefit by enabling an entity to account for the credit "above the line"; that is within pre-tax income, likely to be shown as a direct reduction to gross R&D expenditure or a separate item of income.

Such a conclusion would apply under IFRS, current "old" UK GAAP and for entities adopting FRS 102.





Forecasting

One of the key factors in implementing the ATL regime is to make the benefit more recognizable to companies and to ensure the benefit goes to the departments performing the R&D. Now that the R&D benefit is "above the line," companies may wish to include the R&D benefit in their budgets and financial statements, thereby allowing for earlier recognition. In order to do this, auditors will require that the amount of ATL benefit recognized in the claimant's accounts is reasonably stated.

To ensure this is the case, the following should be considered:

- Understand what factors drive eligibility in the relevant claimant entity, for example:
  - Strong claim history – amounts of qualifying spend agreed with HMRC, business units included within claims
  - Number of large contracts undertaken and/or
  - Volume of work in various divisions.
- Carry out the preparation of a forecast model using key drivers/budgeted costs as the basis of the model, including early engagement with HMRC to secure agreement to methodology and key principles.
- Carry out a review at the accrual stage on the key drivers using a level of diligence appropriate for the company's auditors to determine the reasonableness of the benefit recognized. This may include but not be limited to:
  - Discussions with key technical staff and
  - Project list review.
- Best practice for a robust forecast is for companies preparing claims in-house to carry out the claim preparation earlier than normal, e.g., preparing a claim on a nine month basis with a catch up period for the last quarter.

Patent Box – downstream and oil field services companies

The Patent Box is applicable to all companies holding qualifying intellectual property rights ("QIPR") or an exclusive license in respect of QIPR, regardless of their industry. Companies liable to UK corporation tax and earning a profit from exploiting patented products, processes or services can benefit from the Patent Box regime. As stated above, the regime is not available for ring-fenced income. The company must also own or exclusively license-in the patents. Either the company or another company in the same group must have undertaken significant activity to develop the patent or its application and, if the development was done by a group company other than the patent holder, the holder also must be actively involved in the decision-making connected with exploiting the patent, i.e., it must be responsible for the decisions related to the commercialization of the patent or license portfolio ("active ownership" condition). This allows flexibility for both group-wide activities and products incorporating purchased bundles of patents to qualify.

The Patent Box applies if a company owns or exclusively licenses-in patents granted by one of the following:

- UK Intellectual Property Office
- European Patent Office or
- The following countries in the European Economic Area: Austria, Bulgaria, Czech Republic, Denmark, Estonia, Finland, Germany, Hungary, Poland, Portugal, Romania, Slovakia and Sweden.

Companies liable to UK corporation tax and earning a profit from exploiting patented products, processes or services can benefit from the Patent Box regime.

Calculation of Patent Box benefit

The philosophy underlying the Patent Box is that profits associated with patented technologies will be taxed at 10 percent, so it is necessary to split the company's profits that are related to patents from those that are not. However, the legislation provides a relatively straightforward mechanism to calculate the profits associated with patented technologies, which means that companies are not required to maintain any detailed profitability records of their technologies.

This is achieved based on turnover: companies will be required to separate income streams related to patented technologies from those that are not. The sale of patented products and the royalty income received from licensing patented technologies are amongst the turnover categories related to patents. For companies providing services or using their patents in processes that lead to unpatented products, the legislation requires the calculation of a notional royalty that the patents could be valued at as the basis for the calculation of the patent-related turnover.

It has been estimated that the Patent Box will cost the UK Exchequer around £1 billion per annum through the reduced tax rate. This is clear evidence of the UK's continuing push to become, and remain, the preferred destination for innovation activities.

Potential industry issues

The following points may complicate the calculations for companies in the industry:

- Downstream patents are likely to be process patents.
- The possibility of mixed income streams, e.g., product patents and process patents, add complexity and computational uncertainty to the analysis.
- In global groups, the UK company may not have the legal or beneficial ownership of the patent (beneficial ownership obtained through participation in cost sharing arrangements is a valid title) and an analysis of the licensing agreements will be required.

This is clear evidence of the UK's continuing push to become, and remain, the preferred destination for innovation activities.

Conclusion

The UK is becoming a very attractive place for companies which invest in R&D and have a culture of innovation. The changes to the R&D regime discussed above will lead to a new set of R&D claimants and the Patent Box regime will further encourage companies to invest in development.

Australia: Budget 2013 and other changes

Federal Budget 2013-14

Against the backdrop of a larger-than-expected national deficit, the Australian federal government announced a range of proposed amendments to the tax system as part of its 2013-14 Budget (the "Budget"). As discussed in the Budget, a number of the proposed tax measures are aimed at "protecting the corporate tax base from erosion and loopholes" rather than forming part of a comprehensive reform of the tax system.

Some of the proposed changes that specifically have an impact on the oil and gas industry are discussed in this update.

Thin capitalization reform

The Budget proposals targeted debt funding in order to reduce the amount of interest deductions claimed in Australia, which the government perceives as excessive. The government sees this as part of its response to the OECD's project on base erosion and profit-shifting ("BEPS").

The safe harbor debt limit is proposed to be reduced from a 75 percent to a 60 percent debt-to-net asset ratio …

The proposed changes include:

- The safe harbor debt limit is proposed to be reduced from a 75 percent to a 60 percent debt-to-net asset ratio
- The arm's length debt test should be retained; however, a review would be commissioned on the administration of this test and the circumstances in which it should apply and
- The worldwide gearing test would be extended to inbound investors, thereby allowing Australian operations to be geared at the same level as the worldwide group, even if that exceeds the safe harbor debt limit.

Each of these proposed changes would affect income years commencing on or after 1 July 2014.

The proposed changes are likely to have a significant effect on the oil and gas sector. Businesses would need to test their debt levels against the reduced safe harbor limit and evaluate their options, including revaluing assets and/or restructuring funding to minimize denial of interest deductions.

Denial of interest deductions

The Australian government's proposed reform of debt funding arrangements includes a denial of interest deductions on debt used to fund equity investments in foreign subsidiaries. Currently, a deduction may be allowed for interest expense on debt used to fund equity investments in foreign subsidiaries and other non-portfolio equity investments.

This change would affect income years that begin on or after 1 July 2014. This would represent a significant reform by the Australian government and a reversal of the policy decision taken in 2001 (i.e., the introduction of the current thin capitalization regime), which eliminated the need to trace the use of borrowed funds to determine interest deductibility.

Australian multinationals would again be required to trace the use of borrowed funds and face a disallowance of interest expense if the funds are used to fund foreign equity investments rather than domestic operations.

Changes to exemption regime for foreign dividends

Changes were also proposed to be made to better target the exemption regime applicable to foreign non-portfolio dividends received by Australian companies (i.e., dividends to Australian entities on equity interests held in foreign entities greater than 10 percent). These reforms were previously announced as part of the 2009-10 Budget.

Currently, the exemption is available for dividends received from all non-portfolio shareholding interests, including interests that are legal form shares treated as debt for Australian tax purposes (e.g., certain redeemable preference shares). Accordingly, the proposed changes include a removal of the exemption for dividends received in relation to an interest that is classified as debt for Australian tax purposes. This change would apply beginning 1 July 2014.

The Australian government has also proposed to repeal a provision providing for a tax exemption for certain dividends received by a controlled foreign company ("CFC"). Finally, the Australian government has proposed to expand the exemption regime for foreign non-portfolio dividends to include dividend income received through an investment in a trust or partnership.

Changing the write-off period for intangibles used in exploration

Previously, an immediate deduction was available for the cost of acquiring mining rights (including petroleum rights) and information first used for exploration (collectively, "Mining Intangibles"). The Australian government has proposed to change the treatment of these intangibles beginning 14 May 2013. Specifically, the immediate deduction would be removed, and Mining Intangibles would instead generally be depreciated over the shorter of:

- 15 years or
- The effective life of the mine or field that results from the exploration.

An immediate deduction would continue to be available for:

- Expenditures under farm-in/farm-out arrangements
- Costs of acquiring a mining right from a relevant governmental authority (e.g., tenement registration costs)
- Costs of acquiring mining information from a relevant governmental authority (e.g., cost of title searches) and
- Costs incurred by the taxpayer in generating new information or improving existing information.

The Budget also proposed that the tax treatment of exploration expenditures that applies to mining and petroleum entities be extended to geothermal energy.

The measures, if passed, would apply from 14 May 2013 unless the taxpayer has committed to the acquisition of the right or information (directly or indirectly) before 7:30 p.m. Australian eastern standard time (AEST) on 14 May 2013, or they are deemed to have held the right or information before that time in accordance with tax law.

Capital Gains Tax ("CGT") reform for foreign residents

The Budget included proposed changes to the Australian CGT regime as it applies to foreign residents who are disposing of indirect interests in Australian real property, including mining interests.

The first proposed change addressed perceived flaws in the "principal asset test." Dealings (e.g., receivables) between entities within the same tax consolidated group would now be ignored to prevent multiple counting that would otherwise inflate the proportion of non-land assets.

The second change to the principal asset test would treat mining information and other intangibles connected to mining rights as part of those rights, thereby counteracting a recent Federal Court decision.[1]

These changes would increase the likelihood that Australian oil and gas companies would qualify as land rich and therefore that their foreign-resident shareholders would be subject to CGT on disposals of shares. These changes would apply to CGT events occurring after 7:30 p.m. (AEST) on 14 May 2013.

Withholding regime for foreign residents disposing of taxable Australian property

As part of the Budget, the Australian government also proposed the introduction, beginning 1 July 2016, of a 10 percent non-final withholding tax on gross proceeds payable to foreign residents on disposals of taxable Australian property. The withholding obligation would apply irrespective of whether the relevant assets are held on capital or revenue account. This measure would not apply to residential property transactions under AU$2.5 million or to disposals by Australian residents. Details of this measure are subject to further commentary by the Australian government.

CFC reforms

Long-awaited CFC reforms, which were originally announced in the 2009-10 Budget, have been put on hold pending the completion of the OECD's review of BEPS by multinationals. The proposed CFC reforms were endorsed by the Board of Taxation and would enhance the competitiveness of Australian multinationals in foreign markets. It is now unclear whether the reforms will proceed in their current form in light of the BEPS project.

Other changes not included in Budget 2013-14

Further developments regarding the Esso decision

Since our last update, an omnibus bill containing amendments to the Petroleum Resource Rent Tax ("PRRT") regime was introduced into Parliament to give effect to the Australian government's announcement of 14 December 2012 regarding the uncertainties created by the Esso decision. This was passed by Parliament on 28 June 2013 and is now in effect.

Specifically, the new changes address concerns over the deductibility of legitimate expenditure with retrospective amendments designed to:

- Restore the ability of taxpayers to apportion expenditures for PRRT purposes and
- Allow taxpayers to deduct expenditures incurred under contract with an unrelated party for project services or operations but
- Require a look-through approach to be generally applied where the taxpayer contracts with a related party (including a joint venture party).

The practicalities of complying with the proposed amendments will need to be carefully considered as they could have far-reaching implications.

1 See *Resource Capital Fund III LP v Commissioner of Taxation* [2013] FCA 363.

The omnibus bill referred to above also included provisions requiring the Commissioner to publish the amount of PRRT payable each year by all entities … .

Publication of tax payment information

The omnibus bill referred to above also included provisions requiring the Commissioner to publish the amount of PRRT payable each year by all entities and income tax payable for entities of a certain size in an attempt to improve the transparency of the tax system. These are also now in effect after the bill was passed by Parliament.

Administrative Appeals Tribunal ("AAT") case – meaning of exploration for PRRT

The AAT recently published its decision in the case *ZZGN v Commissioner of Taxation*, [2013] AATA 351, regarding the meaning of exploration for PRRT purposes.

In a lengthy judgment, the AAT found that the term "exploration," as relevant for PRRT purposes, should have its ordinary everyday meaning and contemplates:

- The use of any range of survey techniques to identify prospective oil or gas fields together with any scientific or technical analysis necessarily associated with evaluating their results and
- The drilling of appraisal wells to provide a more accurate indication of the potential size and quality of the oil and gas reserves.

It was concluded that exploration does not include feasibility studies of the field for future development and production.

As to whether the expenditure was made "in connection with" exploration, the AAT concluded that there has to be shown to be a reasonably direct relationship between the "operations" for which the expenditure has been incurred and the "exploration" for there to be a relevant connection between the two and that a remote and indirect connection will not suffice.

Applying these principles to the facts, the AAT found that some of the expenditure in question was made "in connection with exploration" for the purposes of the PRRT regime, but not all of the expenditure.

This decision has significant implications for PRRT taxpayers and it is critical that the treatment of expenses of the type considered by the AAT be carefully reviewed. The Australian Taxation Office has indicated it intends to provide further guidance by way of a tax ruling.

New South Wales changes to duty on exploration tenements

The Government of New South Wales has proposed significant changes to the stamp duty payable on dealings with exploration tenements beginning 1 July 2013.

The proposed changes include:

- The definition of "land" would be expanded to include exploration licenses, not just mining leases and mineral claims
- The value of a mining tenement would be determined with respect to the value of any mining information relating to that tenement and
- The value of anything fixed to the land over which the tenement is granted would also be included in the value of the mining tenement itself.

The proposed legislation is currently being debated in the New South Wales State Parliament and has not yet been enacted.

Increase in fringe benefits tax ("FBT") rate

The FBT rate has been increased by 0.5 percent to 47 percent with effect from 1 April 2014. This change will ensure that the FBT rate remains aligned with the top marginal tax rate plus the recently announced 0.5 percent increase in the Medicare levy, which has been enacted.

Norway: Reductions in allowable depreciation and applicable tax rates

Background

Companies which have been granted a license to explore for and produce petroleum resources on the Norwegian Continental Shelf are subject to a special petroleum tax regime. Pipeline transportation of petroleum produced on the Norwegian Continental Shelf (which also requires a license) is also subject to the special petroleum tax regime.

Profits from petroleum exploitation and pipeline transportation are subject to the following taxes:

- Ordinary petroleum tax at a current rate of 28 percent and

- Special tax at a current rate of 50 percent.

The tax base for calculating the two taxes generally is the same except that:

- Net financial costs may be deductible to a greater extent against the basis for ordinary petroleum tax than special tax and

- An additional depreciation deduction, referred to as "uplift," is granted when calculating the basis for special tax purposes but not for ordinary petroleum tax purposes.

Special tax may not be deducted from the base of the ordinary petroleum tax or vice versa.

The uplift is calculated on costs incurred in connection with development carried out under a license. Prior to the effective date of the recent developments discussed below, the uplift has been 7.5 percent of the annual development costs from and including the year the costs are incurred and the three following years, i.e., four years in total. The total uplift has therefore been a maximum of 30 percent. Insofar as the uplift cannot be utilized, it may be carried forward (together with other losses) indefinitely. The 30 percent uplift implied that development costs in total were depreciated by 130 percent when calculating the base for future special tax.

Reduced uplift

On 5 May 2013, the Norwegian government announced that the uplift maximum described above would be reduced from 30 percent to 22 percent. This was followed up with a white paper put before the Norwegian Parliament on 7 May 2013. The proposed changes passed Parliament on 17 June 2013 and were formally adopted as law on 21 June 2013.

Subject to transition rules, the annual uplift will be reduced to 5.5 percent (over four years) on costs incurred after 4 May 2013, making the total maximum uplift 22 percent. Depending on the discount rates used, the change is likely to increase the after tax cash investment for the development of a field by at least 10-15 percent (assuming 100 percent equity financing).

The following transition rules apply:

1. For development costs covered by a plan for development and operations ("PDO") or a plan for installation and production ("PIO") received by the Ministry of Oil and Energy ("MOE") before 5 May 2013, the reduced uplift applies only to costs incurred during the year following the year in which production commences. As a starting point, a PDO needs to be filed for each "petroleum deposit." The term "petroleum deposit" is defined as follows in the Norwegian Petroleum Act: "an accumulation of petroleum in a geological unit, limited by rock characteristics by structural or stratigraphic boundaries, contact surface between petroleum and water in the formation, or a combination of these, so that all the petroleum comprised everywhere is in pressure communication through liquid or gas."

   Installations to be used in petroleum production will be covered in a PDO. A PIO will typically cover installations not directly linked to extracting petroleum from the ground and where the installation could be used by more than one field such as pipelines, certain cooling systems, etc.

On 5 May 2013, the Norwegian government announced that the uplift maximum described above would be reduced from 30 percent to 22 percent.

2. For development costs incurred subsequent to an application not to prepare a PDO or PIO and for which the application is received by the MOE before 5 May 2013, the reduced rate applies only to costs incurred in the year following the year in which production commences. Note that such costs would not be incurred before the MOE agrees that a PDO or PIO is not necessary.

   Applications (and approvals) not to prepare a PDO are typically made if the petroleum deposit is close to a deposit already covered by an approved PDO provided that production from the petroleum deposit may come from installations covered by the existing PDO.

   Applications (and approvals) not to file a PIO would be relevant where the investments are minor and they would not have any significant environmental effects.

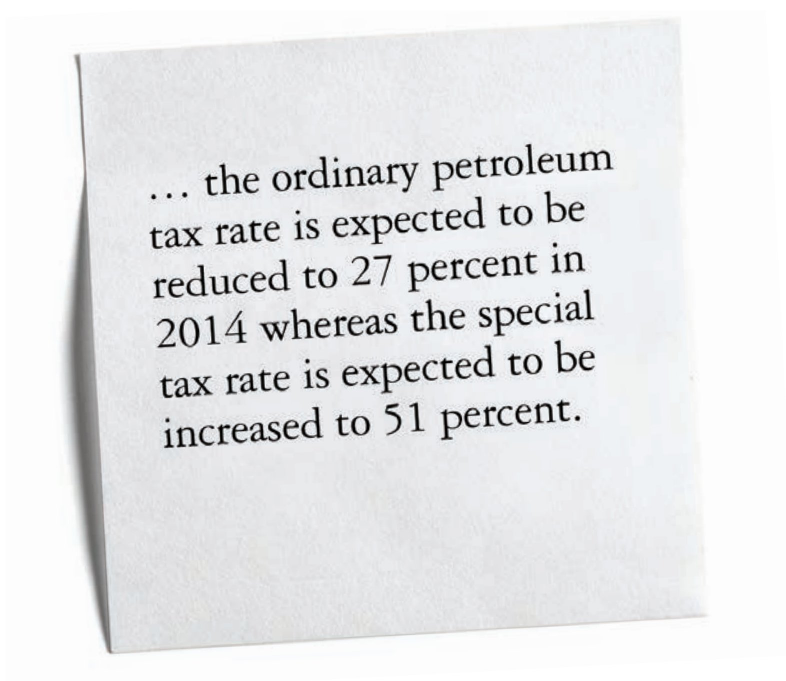
3. For development costs incurred subsequent to a notification (and subsequent approval) received by the MOE before 5 May 2013, to the extent that there will be significant deviations from a previously filed PDO or PIO, the reduced rate applies only to costs incurred the year following the year in which production commences. Deviations from a PDO filed would typically be significant if they would affect the production schedule, joint activities with other licensees on other blocks, or the decommissioning plan.

4. Insofar as the applications or notifications regarding PDOs mentioned under items 1, 2, or 3 above relate to an additional investment in a production license, the 7.5 percent annual uplift applies to costs incurred up to and including the year in which the additional investment starts producing.

In addition to the direct economic effect these new uplift provisions will have on exploration and production ("E&P") companies, it is likely to be relevant to suppliers of E&P companies as well. An expected indirect effect is that investments in some fields that have previously been considered for development may be postponed or scrapped entirely.

Reduced tax rates

It should also be noted that the ordinary petroleum tax rate is expected to be reduced to 27 percent in 2014 whereas the special tax rate is expected to be increased to 51 percent. The reduction of the ordinary petroleum tax rate should be viewed in conjunction with the government's announcement that the ordinary corporate tax rate will be reduced to 27 percent in 2014.



Russia: Recent developments

In addition to a new property tax incentive, several changes have recently been introduced to the Russian tax legislation. The key changes applicable to the oil and gas sector can be summarized as follows:

Accelerated depreciation cancelled for certain types of fixed assets

Historically, taxpayers have been able to depreciate fixed assets at an accelerated rate if such assets are utilized under hazardous or extreme environmental conditions. Such conditions include any natural and/or artificial factors which may cause increased depreciation of fixed assets in the process of their use or any technological environment (e.g., explosion-hazardous, fire-hazardous, toxic, etc.) which may be the cause of an emergency situation.

The same rule could be applied to depreciating fixed assets if multiple shifts of persons work with such assets per day.

Under new legislation, the accelerated depreciation method for such assets may only be applied to those fixed assets which have been placed into service before 1 January 2014.

Excise tax rates continue to increase

Excise tax rates for oil products increased on 1 July 2013. Previous and current rates are shown below and indicated in rubles per ton. The rates will continue to increase in 2014 and 2015.

	1st Half 2013 – RUB Per Ton		2nd Half 2013 – RUB Per Ton	
Gasoline/Diesel Fuel	**Gasoline**	**Diesel Fuel**	**Gasoline**	**Diesel Fuel**
below Class 3	10,100	5,860	10,100	5,860
Class 3	9,750	5,860	9,750	5,860
Class 4	8,560	4,934	8,960	5,100
Class 5*	5,143	4,334	5,750	4,500
Motor oil	7,509			
Straight-run gasoline	10,229			

* Classes represent European emission standards (i.e., Euro-3, Euro-4, Euro-5)

Property tax exemption for infrastructure cancelled

The property tax exemption on infrastructure property, including oil and gas pipelines, was cancelled in January 2013. The new property tax rate for infrastructure property for 2013 is 0.4 percent. This rate will continuously increase until 2018 to a rate of 1.9 percent. Common infrastructure property to which the exemption applied primarily included state-controlled Russian monopolies (e.g., Transneft, Gazprom, and Russian Railways). It is expected that the tariffs charged by these companies to their customers will rise accordingly.

Property tax exemption for movable property introduced

New legislation also introduced a property tax exemption which applies to all types of movable property placed into service on or after 1 January 2013. It is expected that this exemption will be in effect for five years and will allow taxpayers to save more than RUB150 billion (approximately US$5 billion) collectively.

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Talk to us

For additional information regarding global oil and gas resources, please visit **www.deloitte.com/oilandgas**.
If you have questions or comments regarding the content of the Global oil & gas tax newsletter, please contact one of the following global oil and gas tax leaders:

Julian Small
Oil & Gas Tax Leader | Global
Partner | Deloitte UK (London)
Tel: +44 20 7007 1853
Email: jsmall@deloitte.co.uk

Harold Payne
Oil & Gas Tax Leader | Asia Pacific
Partner | Deloitte Australia (Perth)
Tel: +61 8 9365 7202
Email: hpayne@deloitte.com.au

Carlos Vivas
Oil & Gas Tax Leader | Brazil
Partner | Deloitte Brazil (Rio de Janeiro)
Tel: +55 (21) 3981 0482
Email: cavivas@deloitte.com

Brian Pyra
Oil & Gas Tax Leader | Canada
Partner | Deloitte Canada (Calgary)
Tel: +1 403 503 1408
Email: bpyra@deloitte.ca

Alex Law
Oil & Gas Tax Leader | Middle East
Partner | Deloitte Middle East (Dubai)
Tel: +971 4 5064700
Email: alexlaw@deloitte.com

Dirk Jan van Klink
Oil & Gas Tax Leader | Netherlands
Partner | Deloitte Netherlands (Rotterdam)
Tel: +31 8828 81323
Email: dvanklink@deloitte.nl

Andrey Panin
Oil & Gas Tax Leader | CIS
Partner | Deloitte Russia (Moscow)
Tel: +7 (495) 787 06 00 (ext. 2121)
Email: apanin@deloitte.ru

Roman Webber
Oil & Gas Tax Partner | UK
Partner | Deloitte UK (London)
Tel: +44 20 7007 1806
Email: rwebber@deloitte.co.uk

Jeff Wright
Oil & Gas Tax Leader | U.S.
Partner | Deloitte U.S. (Houston)
Tel: +1 713 982 4940
Email: jeffwright@deloitte.com

Additional Local Contacts for this Edition

Petter Grüner
Oil & Gas Tax Partner | Norway
Partner | Deloitte Norway (Oslo)
Tel: +47 23 27 96 05
Email: pgruner@deloitte.no

Kylie Gregge
R&D Tax Services Partner | UK
Partner | Deloitte UK (London)
Tel: +44 20 7007 0264
Email: kgregge@deloitte.co.uk

Designed and produced by The Creative Studio at Deloitte, London. 28238A