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Global oil & gas tax newsletter
Views from around the world

In this issue

July 2012

Spotlight on the United States: Shale plays and indirect taxes – what is all the noise about?

Just open any newspaper and chances are there is another headline announcing a recent development in the ongoing growth – and surrounding debate – around the natural gas industry in the United States. Industry sources report renewed interest in the development and production of underground natural gas domestic resources available for extraction using horizontal drilling and fracturing technology, particularly in several key shale regions. State and local government officials are looking to tax this increased activity as an additional source of revenues, yet tax legislation and policies often have not been established for production processes in this rapidly changing industry landscape.

In this climate of change and uncertainty, market forces are at work. Many companies recognize the opportunities in drilling and production within the shale plays and are actively investing in domestic natural gas development. These investors may be new to the energy market or may have a long history of oil and gas development. However, all will be faced with understanding and applying the evolving tax rules to their own set of facts. With change comes potential opportunities – and tax planning is no different. The following is a discussion of some of the more notable state and local tax trends and opportunities related to the shale industry. However, because this is an evolving area of the tax law and policy, the following information is based upon common interpretations and industry experience and should be carefully considered for its applicability to a given transaction or scenario.

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Marcellus and Utica Shale Regions: Pennsylvania, West Virginia, Ohio and New York

The Marcellus Shale formation covers several eastern states, with the vast majority of shale resources falling within the boundaries of Pennsylvania. The Marcellus shale is one of the largest natural gas formations and lies approximately 4,000 to 8,000 feet below the surface. Beneath this formation lies the Utica shale formation, which many believe contains even greater natural gas reserves.

Historically, this region's state and local tax environment reflected a rich industrial heritage steeped in coal mining and industrial manufacturing. However, recent changes reflect a climate of state budgetary challenges and increasing pressure on local governments related to concerns surrounding potential environmental impacts of horizontal drilling and fracturing activities as well as strains on local infrastructures. Industry activities have largely stalled in New York due to bans by many localities on fracturing activities, and Pennsylvania drilling activities have been impacted by the recent authorization of locally-imposed gas well fees. As a result, state and local taxes and industry regulations are being debated in the public forum and remain a significant concern of those in the industry. As state and local authorities impose and audit the application of these taxes on new fracturing technology and related industry activities, it is anticipated that additional policy information and clarification will become available to the industry and the practitioners that serve them.

Pennsylvania law now permits counties with unconventional gas wells located within their borders to impose a per-well fee on producers.

Pennsylvania

Natural Gas Well Fees

On 13 February 2012, Pennsylvania Governor Tom Corbett signed into law an amendment that permits county governments to impose an unconventional gas well fee, effectively removing Pennsylvania's distinction as the nation's largest gas-producing state that does not impose a levy on the activity.[1]

Pennsylvania law now permits counties with unconventional gas wells located within their borders to impose a per-well fee on producers. County governments may enact the fee directly or be required to do so by municipalities located within. The fee is imposed on an annual sliding scale that is dependent upon the average annual price of natural gas and adjusted by the Consumer Price Index.[2] The initial report and payment are due by 1 September 2012 and subsequent reports and payments are due each 1 April thereafter for the previous calendar year. Where a producer certifies to the Department of Environmental Protection of the Commonwealth that an unconventional gas well has ceased production and has been adequately plugged, the fee will no longer apply.[3] With the recent drop in natural gas prices, the imposition of this additional fee has caused many producers to evaluate the economics of production in certain localities and shift natural gas production activities elsewhere until natural gas prices recover and stabilize.

Sales and Use Taxes

Natural gas drilling and extraction activities have long been included in the Pennsylvania Department of Revenue's definition of mining activities.[4] Pennsylvania provides a broad sales and use tax exemption that applies to, "[t]he purchase or use of tangible personal property or services performed thereon by a person engaged in the business of mining[,]" including exploring, blasting, mining, extracting, and refining activities. For the purchase of machinery, equipment, parts and supplies to qualify for the exemption, the item must be predominantly (greater than 50%) used directly in mining activities.[4]

1 Pa. Stat. Ann. tit. 58, § 2302.

2 The Consumer Price Index is a measure of the change in prices over time, based upon the spending patterns of two population groups, (urban wage earners and clerical workers) considered to be representative of the general populations.

3 Pa. Stat. Ann. tit. 58, § 2302 (e).

4 61 Pa. Code § 32.35; see also, 72 P.S. § 7201(k)(8).

The factors that determine whether an item of property is directly used are: (1) physical proximity, (2) temporal proximity, and (3) the existence of an active causal relationship between the use of the property and the mined product. It is important to note that in considering the existence of an active causal relationship, the characterization of a particular property as necessary or essential to the mining business does not necessarily mean that the property is used directly in mining operations, even if it is required by law.[6] However, the Pennsylvania exemption does include machinery, equipment, parts, foundations and supplies which are used beyond the actual drilling and extraction process. The exemption covers, with few exceptions, the transportation of the gas during processing and the transportation of production personnel. Finally, the exemption applies to the purchase of machinery, equipment, parts, foundations and supplies that are directly and predominantly used to handle or store the natural gas or byproducts during production.[7] A 2010 ruling provided clarification to the natural gas industry by confirming that the mining exemption would apply to the performance of hydraulic fracturing activities.[8] Furthermore, the ruling also confirmed that the provision of fracturing services by a third-party service provider is not subject to Pennsylvania sales tax, and these service-providers are likewise entitled to claim the mining exemption on their purchases of items that are directly used in mining activities.[9]

Pennsylvania's Mining Regulation 32.35 provides that the following tangible personal property, if predominantly used in mining operations, is generally considered to be consumed directly in mining operations and is therefore exempt from the sales/use tax:

1) digging and extracting equipment;

2) earthmoving equipment;

3) drainage pumps, pipes, valves, fittings and packing;

4) lighting equipment and supplies used to light production activities;

5) protective devices worn by production personnel in their work;

6) waste extraction and removal equipment used in the course of production operations;

7) pollution control devices used to control, abate or prevent air, water or noise pollution;

8) dozers and graders and materials used for backfilling and reclamation of underground shafts when required by law;

9) property used to test and inspect the product during actual mine production;

10) property used directly in research activities, provided the object of the research is the production of a new or improved product or method of producing a product; and

11) replacement parts used to replace worn parts on exempt equipment and operating supplies used in the operation of the exempt equipment.

The same regulation provides that the purchase of the following tangible personal property is not considered to be consumed directly in the mining operation, so it would not be exempt from the sales/use tax:

1) motor vehicles required to be registered under the Vehicle code;

2) tangible personal property used in the construction, reconstruction, repair, maintenance or improvement of real estate;

3) maintenance facilities including tools, equipment and supplies used in performing maintenance, service and repair work and the general cleaning of mining property;

A 2010 ruling provided clarification … by confirming that the mining exemption would apply to the performance of hydraulic fracturing activities.

5 72 P.S. § 7201(k)(8); 61 Pa. Code § 32.35(a).

6 72 P.S. § 7201(k)(8); 61 Pa. Code § 32.35(a)(iii).

7 72 P.S. § 7201(k)(8); 61 Pa. Code § 32.35(a)(2).

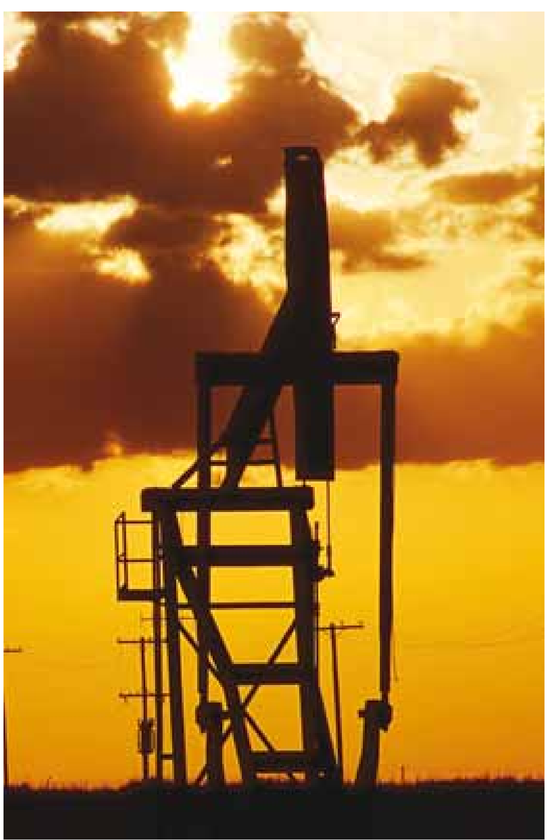
8 Legal Letter Ruling No. SUT-10-003, Pennsylvania Department of Revenue, 15 September 2010.

9 *Commonwealth v. R.G. Johnson Co*., 433 A.2d 465 (Pa.1981).

4) property used in managerial, sales, or other nonoperational activities, including equipment and supplies used in safety and fire prevention, employee comfort, space illumination, pre-mining activities (property used to transport employees, property and storage facilities), post-mining activities (equipment used after the final mining operation), and waste disposal other than in the course of production operations; and

5) equipment that would qualify for the mining exemption will not qualify if purchased by an entity that does not use or consume it in a mining operation, even if they give it to a business engaged in the extraction of natural gas.[10]

One of the most significant activities associated with the expanded areas for extracting natural gas is the construction of access roads and pads for production-related equipment. Pennsylvania sales and use tax statutes consider the construction contractor to be the consumer of all materials that are used, consumed, or permanently installed into real estate. Significant amounts of stone and aggregate are purchased for installation into access roads and pads associated with well construction.



The challenge for well owners and their construction contractors is the allocation of costs between taxable and nontaxable items.

Therefore, the purchase of the stone, aggregate or other paving materials for road or bridge construction would be taxable at the time of purchase by the contractor. However, it appears that these same materials would qualify for exemption when used to construct the well pad that serves as a foundation for exempt drilling and fracturing equipment.[11] The challenge for well owners and their construction contractors is the allocation of costs between taxable and nontaxable items. The Pennsylvania Department of Revenue has not provided formal guidance in this regard. Due to the significant amount of taxes associated with this issue, owners are encouraged to proactively work with their contractors to account for the costs separately so that the sales tax is paid only on the taxable portion.

The common industry practice of moving production equipment and vehicles across state lines provides another challenge for sales and use tax compliance. However, the mining exemption does not apply to vehicles required to be registered under the Vehicle Code. Since the International Registration Plan ("IRP")[12] does not change vehicle registration requirements, vehicles and trailers are subject to tax regardless of whether they are registered under the IRP. Although the mining exemption does not apply to motor vehicles, there may be planning opportunities related to vehicles arising from varying state and local tax rates and state vehicle titling requirements.[13] Note that otherwise taxable equipment brought into Pennsylvania may qualify for an isolated sales exemption if the sales are infrequent and nonrecurring and are made by a non-vendor or a vendor who is not a vendor of the type of equipment sold.[14] Additionally, Pennsylvania provides a credit for sales or use tax paid on purchases made outside the state where the tangible personal property is brought into the state for use, provided the state to which the sales or use tax was paid also provides similar relief for taxes paid on purchases made and used in the other states.[15]

10 Pennsylvania Dept. of Revenue, Tax Update, Number 159, Dec. 2011/January 2012 (pg. 6).

11 72 P.S. § 7201(k)(8); 61 Pa. Code § 32.35(a)(2).

12 The International Registration Plan is a registration reciprocity agreement among the states of the United States, District of Columbia and provinces of Canada, which provides for the payment of apportioned registration fees based on total miles driven in all jurisdictions. It is available for vehicles having two axles and exceeding 26,000 pounds or having more than two power axles.

13 PA Title 75, Vehicles, Part II, Chapters 11, 13, 61. Title 75 provides all of the titling, registration and licensing requirements for vehicles purchased and/or used within the state.

14 61 Pa. Code § 32.1 states that isolated sales, exempt from sales tax, can occur no more than three times or seven days in one calendar year. The sales of such property also cannot occur at a location from which another business is making a similar sale of the same taxable property or services.

15 72 P.S. § 7206(a).

This natural resource-rich state has a long-standing history of a favorable tax environment related to mining or production of resources ….

West Virginia

Sales and Use Tax

The Marcellus Shale formation also extends into West Virginia. This natural resource-rich state has a long-standing history of a favorable tax environment related to mining or production of resources, including coal and natural gas. However, West Virginia is unlike most other states in that it provides a refundable sales and use tax exemption applicable to the sale of services, machinery, supplies and materials directly used or consumed in the production of natural resources.[16] Sales tax must be charged by vendors unless the customer provides a certificate or permit number issued by the State to the seller that permits the customer to handle the responsibility for their own use tax.[17] Furthermore, unlike most states, West Virginia imposes its sales tax on nearly all services, with an exception for professional and personal services.[18]

For these purposes, the production of natural resources includes exploring, developing, and drilling. Well-stimulation activities are also considered part of production and include activities such as logging, perforating, or fracturing. Well-completion installation activities for casing, tubing and other machinery and equipment, including the installation of the gathering system or other pipeline to transport the oil and gas produced, are also covered by the exemption. Finally, environmental activities associated with any service work performed on the well or well site during installation as well as after production of the well has initially commenced are all considered part of the production of natural resources.[19]

For purposes of the exemption, West Virginia's Code § 11-15-2 provides that only the following uses of property and/or consumption of services constitute direct use:

1) tangible personal property physically incorporated into the finished product;

2) property or services causing a direct physical, chemical or other change upon the product being produced;

3) transportation or storing of property undergoing production;

4) measuring or verifying changes in property directly used in the production of natural resources;

5) physically controlling or directing the physical movement of property undergoing production or recoding the flow of property undergoing production;

6) serving as an operating supply for property undergoing production;

7) maintenance or repair of property, including maintenance equipment used directly in the production of natural resources;

8) storage, removal or transportation of economic waste resulting from the production of natural resources;

9) pollution control activities directly related to the production of natural resources;

10) safety and/or security activities directly related to the production of natural resources; and

11) any other integral and essential part of the production of natural resources.

Well owners and developers along with service providers to this industry that have a significant presence in West Virginia are encouraged to obtain permission from the West Virginia Department of Taxation to handle their own sales and use tax decisions via a permit to do so referred to as a Direct Pay Permit. By obtaining a permit, they will have the ability to more effectively monitor the appropriate application of the sales tax charged by vendors and subsequently apply the exemption provisions to their purchases and report the appropriate tax to West Virginia based on identifying taxable purchases.

Ohio

Sales and Use Tax

Similar to Pennsylvania and West Virginia, the Marcellus and Utica shale regions extend into Ohio. As with Pennsylvania, Ohio sales and use tax laws provide a sales and use tax exemption related to mining activities. Ohio provides a sales and use tax exemption for tangible personal property used or consumed directly in production of tangible personal property for sale by mining.[20]

16 W. Va. Code § 11-15-9(b)(2).

17 W. Va. Code § 11-15-9(b).

18 W. Va. Code § 110-15-123.4.3.7.

19 W. Va. Code § 11-15-2(b)(14)(B).

20 O.R.C. § 5739.02(B)(42)(a).

This includes extraction from the earth of all substances that are classed geologically as minerals as well as the production of crude oil and natural gas.[21] The exemption also applies to the exploration for crude oil and natural gas.[22]

At first blush, Ohio's statute, O.R.S. § 5739.02(B)(42)(a), and mining regulation, 5703-9-22, appear to provide a broad mining exemption. The regulation provides that production, in addition to drilling, includes transportation of the substance extracted. Additionally, the aggregate or other materials incorporated into a temporary private road that is used principally for the transportation of the substance extracted qualifies for an exemption. Finally, any physical protection items for production employees when used principally in the excavation or transportation of the extracted substance would qualify. However, these exemptions only apply when production of the substance extracted is not completed at the mine, but the operator transports the extracted substance to a place where the mine operator will further process it. The exemption would not apply to pipelines used for gathering, transmission, or transportation, where the natural gas is not going to be further processed by the mine operator.

Although Ohio's rule also provides a sales and use tax exemption for repairs or maintenance of property used in the extraction and transportation of the substance extracted, Ohio has limited this exemption as it relates to drilling rigs.[23] In this 1994 decision, the Ohio Board of Tax Appeals provided that the repair of the electrical system and the mud pump on a drilling rig were exempt, but repairs to a collar, pipe tub, handrail and other various repairs on the drilling rig were taxable. This limits the repair or maintenance exemption to only those parts of the drilling rig used directly in the drilling process.

As noted above, the Ohio sales and use tax exemptions only apply to tangible personal property used *directly* in the production process. Ohio has numerous court cases indicating that the exemptions related to production begin with the actual drilling and end when the person conducting the mining operation completes his production processing.[24] As a result, the purchase of many items associated with hydraulic fracturing such as machinery, equipment, and other tangible personal property used in site preparation, mixing of chemicals prior to drilling, and storing of water or chemicals does not fall within the sales/use tax exemption.

As a result, the purchase of many items associated with hydraulic fracturing … does not fall within the sales/use tax exemption.

Additionally, machinery, equipment and other tangible personal property used in operations outside the drilling process such as site reclamation, hauling of water or waste to or from the site are examples of property that, although necessary for the production process, do not qualify for the exemption since they are not used directly in the production process.

Eagle Ford and Barnett Shale Regions: Texas

The Eagle Ford shale formation extends across Texas from the Mexican border up into the eastern part of Texas, and is roughly 50 miles wide and 400 miles long with an average thickness of 250 feet. The shale play is a hydrocarbon producing formation and is very important due to its capability of producing more gas and oil than other traditional shale plays. Eagle Ford contains a much higher carbonate shale percentage, upwards of 70% in southern Texas, than other plays. This makes the shale more brittle and therefore more easily fractured. The shale play becomes shallower and the shale content increases as it moves to the northwest. In 2011, there were 368 producing oil leases on schedule and by comparison, 2010 had only 72 producing oil leases, and 40 in 2009. Similarly, in 2011 there were 550 producing gas wells on schedule. 2010 had only 158 producing gas wells and 2009 had 67.[25]

The Barnett Shale region is located in north central Texas and is a hydrocarbon-producing geological formation of great economic significance to Texas. The Barnett shale formation consists of sedimentary rocks and the productive part of the formation is estimated to stretch from the city of Dallas west and south, covering 5,000 square miles (13,000 km²) and at least 18 counties.[26] Due to the great increase in production of both of these shale plays in Texas, the need for sales and use tax assistance with companies new or expanding to these plays is growing.

21 *Id*.

22 *Id*.

23 *CVAS Drilling, Inc. v Tracy*, Ohio Board of Tax Appeals, No. 92-A-346, 10 June 1994.

24 *K.S.T. Oil & Gas Co., Inc. v Tracy*, 73 Ohio St. 3d 97, 652 N.E. 2d 678 (1995); *Lyons v Limbach*, 40 Ohio St. 3d 92, 532 N.E. 2d 106 (1988), *Kilbarger Construction, Inc. v Limbach*, 37 Ohio St. 3d 234, 525 N.E. 2d (1988).

25 Railroad Commission of Texas, http://www.rrc.state.tx.us/eagleford/index.php.

26 Railroad Commission of Texas, http://www.rrc.state.tx.us/barnettshale/index.php.

Unlike some of the other aforementioned states, Texas does not have a mining exemption in its sales tax code.

Sales and Use Tax

Unlike some of the other aforementioned states, Texas does not have a mining exemption in its sales tax code. However, Texas has a manufacturing exemption for equipment and replacement parts, consumable supplies and materials used in manufacturing, including pollution control materials and equipment. For many years Texas has considered the extraction of minerals to be mining[27] and, therefore, subject to the state sales tax. However, some above-ground processes, such as separation, removal of water, or injection of products such as odor or corrosion inhibitors, are considered manufacturing operations and, therefore, exempt from the sales tax.[28] Some oil and gas companies are now challenging the State's long-standing policies and are trying to extend the manufacturing exemptions to down-hole equipment and supplies.

Texas Tax Code 151.318 outlines the sales tax exemptions allowed by the State for manufacturers. Many of these exemptions apply to the activities of the oil and gas industry. The tax code has a fairly broad definition of manufacturing that encourages qualifying businesses to operate in Texas. The Texas sales tax exemption for manufacturing includes the purchase/use of tangible personal property beginning with the very first stage in the production process and ending with the completion of tangible personal property having the physical properties (including packaging, if any) that it has when transferred by the manufacturer to a purchaser.[29] Texas also exempts from tax items used or consumed during the actual manufacturing, processing, or fabrication of tangible personal property for ultimate sale if such items are deemed necessary and essential to the process or make or cause a chemical or physical change to the final product.[30] Similarly, there is another sales tax exemption for items essential to a pollution control process.[31]

Several recent court cases address the issue of whether down-hole activities constitute manufacturing and therefore would allow down-hole equipment and pollution control materials and equipment to qualify for the manufacturing exemptions. In *Southwest Royalties Inc. v. Comptroller*, Tex. Dist. Ct. (30 April 2012), a Texas district court held that a petroleum company's oil and gas production equipment did not qualify for Texas' manufacturing exemption because it was not "directly used" in the company's actual manufacturing of property for sale, but was merely an indirect cause of the chemical/physical changes to the product.[32] Under the facts, the company had used the oil and gas production equipment at issue to bring petroleum to the ground surface. The court explained that while it is undisputed that a physical change occurs when petroleum is brought to the surface of the ground, it is the change of pressure and temperature that directly "intervene to cause the changes to marketable" oil and gas – the oil and gas equipment that brings it to the surface "is merely an indirect cause of the changes."[33] It is important to note that prior to issuing the written decision, the judge had made a ruling from the bench in which he agreed that the manufacturing exemptions applied. The case was re-opened before the final decision was issued and more arguments were made regarding long-standing State policy on mineral extraction and the significant negative financial impact to the State that a manufacturing ruling would bring. The Texas Comptroller of Public Accounts estimated that if the manufacturing ruling stood on these types of items, the refund potential for open years for Texas taxpayers would be approximately US$2 billion, plus annual losses to the State of roughly US$500 million in each subsequent year.[34]

Manufacturing as well as exploration and production companies making significant taxable purchases for their own use in Texas may take advantage of tax savings and other benefits by obtaining a Direct Pay Permit from the Texas Comptroller of Public Accounts, similar to the other states previously mentioned.

27 Comptroller's Decision No. 39,936 (2003).

28 TX Hearing HEARING NO. 43,112; Texas Tax Code 151.318(a)(2)(A) and (B).

29 34 T.A.C. § 3.318(d).

30 34 T.A.C. § 3.300(d)(2).

31 34 T.A.C. § 3.300(d)(6).

32 *Southwest Royalties Inc. v. Comptroller*, Tex. Dist. Ct. (30 April 2012).

33 *Southwest Royalties Inc. v. Comptroller*, Tex. Dist. Ct. (30 April 2012), pg 3.

34 TTARA "Court Decision: Sales Tax Exemption for Property Used in Manufacturing."

By taking responsibility for tax on purchases, the permit holder takes the vendor out of discussions about the applicability of the complex exemptions. More importantly, the permit holder may save up to 2% on Texas local jurisdiction sales tax because the tax is based on the location of first storage or use while tax charged by vendors is, for the most part, based on the local jurisdiction where the vendor is located. Because many vendors are located in jurisdictions with higher tax rates (2% maximum) and many well sites are located outside any taxing jurisdiction (possibly outside of local city limits) or may be located in a lower tax rate jurisdiction, the direct pay permit holder may owe tax at a lower tax rate.

Excise Tax

Separate from the state and local sales and use taxes, an excise tax is imposed at both a U.S. federal and state level on motor fuels such as gasoline and diesel. There are many potential refunds or credits available under U.S. Internal Revenue Code § 6421 for federal excise taxes paid and similar state provisions as well. Some examples include taxes paid for fuel used to power vehicles and equipment used off-road, and also for some alternative fuels (e.g., biofuels). The applicability of the federal and state fuel tax refunds cuts across multiple industries, including but not limited to oil and gas, transportation and oil field services.

Federal and state motor fuels tax registration, compliance and refund filings can be both burdensome and costly, whether operating commercial vehicles, construction or industrial equipment, or on and off-road vehicles. The challenge faced by companies in recovering motor fuel excise taxes is identifying, calculating and documenting proper refund claims.

… it is clear that the complexities of U.S. and state and local taxation at the newly identified shale formations are causing both tax authorities and taxpayers to revisit many long-standing indirect tax laws and their applicability to today's industry changes and growth.

The formulas used are complicated – some are based on miles, some are based on gallons purchased, and some on time or usage – and they vary by taxing jurisdiction. There are more companies utilizing motor vehicles off-road as large equipment is being transported out to the remote sites of the shale formations. It is important to note that the tax paid on the fuel used to transport these vehicles to the fracturing sites is eligible for a refund of the excise tax paid on that fuel.

In summary, it is clear that the complexities of U.S. and state and local taxation at the newly identified shale formations are causing both tax authorities and taxpayers to revisit many long-standing indirect tax laws and their applicability to today's industry changes and growth. As the industry gains more experience, so will the public sector and eventually more guidance should be available to taxpayers. In the meantime, the taxation of a thriving industry will remain a challenge for all involved.

The challenge faced by companies in recovering motor fuel excise taxes is identifying, calculating and documenting proper refund claims.

Canadian Budget proposes modifications to the thin capitalization rules

Budget 2012 proposed substantive amendments to the thin capitalization rules ….

The Canadian Minister of Finance introduced the Harper government's first majority budget ("Budget 2012"), entitled "Economic Action Plan 2012: Jobs, Growth and Long-term Prosperity," on 29 March 2012. Among other tax measures, Budget 2012 proposed substantive amendments to the thin capitalization rules, including:

1. Increasing the restriction on the deductibility of interest on debt from certain non-resident persons (generally, certain non-resident shareholders or persons connected with such shareholders, collectively "specified non-residents") by reducing the permitted debt-to-equity ratio from 2:1 to 1.5:1;

2. Expanding the scope of the thin capitalization rules to debts of partnerships of which a Canadian resident corporation is a member;

3. Treating disallowed interest expense under thin capitalization rules as dividends for Part XIII withholding tax purposes; and

4. Preventing double taxation from arising in certain circumstances where a Canadian resident corporation borrows money from a controlled foreign affiliate.

Reduction of debt-to-equity ratio

The reduction in the debt-to-equity ratio will apply to tax years beginning after 2012. As a result of the amendment, any Canadian resident corporation which is currently subject to thin capitalization rules, or will attract the application of the thin capitalization rules, may need to further analyze its current capitalization structure prior to 1 January 2013.

The reduction in the debt-to-equity ratio will apply to tax years beginning after 2012.

Expansion of thin capitalization rules to partnerships

Under the current thin capitalization rules, partnerships are not subject to the limitation of interest deductibility on debt from specified non-residents. For tax years beginning on or after 29 March 2012, the thin capitalization rules will apply to debts of partnerships where at least one of the partners is a Canadian resident corporation. Partnership debt (and any related interest expense) will be allocated to each partner based on its proportionate share of the partnership's total income or loss for the relevant fiscal period of the partnership. The thin capitalization rules would then apply to any resident Canadian corporate partner and to the extent that the partner's debt exceeds the 1.5:1 debt-to-equity ratio in the current tax year, the partnership's interest deduction will not be denied, but an amount equal to the amount of the excess interest expense will be included in computing the income of the partner.

Disallowed interest expense treated as dividends

Budget 2012 proposed to deem interest expense disallowed under the thin capitalization rules as dividends for purposes of non-resident withholding tax under Part XIII of the Act, *i.e.*, the disallowed interest will be re-characterized as a dividend and subject to Canadian withholding tax of 25% (which may be reduced under the provisions of an applicable tax treaty). Such disallowed interest will be deemed to have been paid as a dividend by the Canadian resident corporation to the specified non-resident at the end of the relevant tax year, even though the particular interest may not have been paid by the end of the relevant tax year.

Foreign affiliate loans

The thin capitalization rules may apply to loans made by a "controlled foreign affiliate" to its Canadian parent corporation. If the loan from the "controlled foreign affiliate" bears interest, such interest would be considered "foreign accrual property income" ("FAPI") and includable in the Canadian parent's taxable income. The combination of the thin capitalization rules and FAPI income inclusion may result in double taxation. Budget 2012 proposed one relieving change to avoid the double taxation. The thin capitalization rules will no longer apply to debt from a "controlled foreign affiliate," provided that the interest is included in the Canadian parent corporation's FAPI. This measure will apply to tax years of Canadian resident corporations which end on or after 29 March 2012.

Self-assessment regulations in Nigeria: The oil and gas perspective

Background

In a bid to clarify and fortify the self-assessment regime in Nigeria, Federal Inland Revenue Service ("FIRS"), the apex tax administrative body in Nigeria, recently issued a set of regulations on self-assessment ("the Regulations"), further to its powers under the FIRS Establishment Act.

Official recognition of the use of tax agents

The Regulations mandate all taxpayers (including oil and gas companies) to use tax compliant consultants as agents for filing returns, where the filing is not done by the taxpayer directly. The agents must be certified members of the relevant professional bodies and FIRS intends to commence the process of accrediting such agents in the near future.

Due dates for filing of returns

The Regulations restate the provision of the Petroleum Profit Tax Act ("PPTA") on the time for filing returns. Companies under the PPTA regime are obliged to file their estimated tax returns within 2 months from the commencement of the relevant accounting period,[35] while the final tax return is required to be filed within 5 months after the end of the relevant accounting period.[36] The final return is expected to be accompanied with evidence of payment of the tax due.

Extension of time for making returns and payment of taxes

While the framework for granting an extension of time for filing annual tax returns remains the submission of a written application (before the due date) to the relevant tax authority, the conditions for granting an extension under the Regulations are now stricter and limited. The conditions include: death of any principal officer of the company, such as Managing Director or Company Secretary, or where the company experiences fire or natural disaster.

Additionally, failure to pay tax on the due date may attract penalties and interest. However, where an approval has been granted for an extension of the time to pay, the company would not be liable for any penalties, but interest may be charged on the amount of tax outstanding.

35 Generally, this would be February for a calendar-year accounting period. This may be different for a company that has just commenced or ceased business.

36 Generally, this would be May of the following calendar-year or relevant accounting period. This may be different for a company that has just ceased business.

Recent changes in oil and gas taxation in Russia

Introduction of new law allowing creation of a consolidated group of taxpayers

Law #321-FZ (the "Law"), allowing creation of a consolidated group of taxpayers, was signed on 16 November 2011 and came into force beginning 1 January 2012. A consolidated group of taxpayers can now be created when one entity directly or indirectly participates in another entity, if the proportion of such participation is not less than 90%.

Participating entities must enter into a formal intercompany agreement to effect the consolidation. Additionally, entities considering creation of a consolidated group of taxpayers must meet certain criteria. As of the date of signing the agreement, the total amount of federal tax for all of the group members must be at least RUB 10 billion for the preceding calendar year. The total amount of revenue from sales and operating income must be at least RUB 100 billion for the preceding calendar year, and financial statement assets must be at least RUB 300 billion as of the first day of the calendar year in which the group is created.

One of the group members must be the responsible party for submitting a consolidated tax return which indicates the overall financial performance of the group, and paying any tax due for the group. If the responsible party does not fulfill the tax liability, the group members will be liable for any tax payments due.

Several of Russia's largest oil and gas companies are already considering consolidation under this new regime.

> Additionally, entities considering creation of a consolidated group of taxpayers must meet certain criteria.

Changes in mineral extraction tax

The tax policy for years 2012-2014, approved by the Government in 2011, aims at equalizing the tax burden on the oil and gas industry. Therefore, the Government plans to increase the tax burden on the gas producers by continuous mineral extraction tax ("MET") indexation. Several changes have already been made in 2011:

1) The Law signed in November 2011 introduced different tax rates for Gazprom and other natural gas producers. The tax rate increased for 2012-2014 compared to the previous year rate. Independent gas producers should calculate their tax rates by multiplying the Gazprom tax rate by the special decreasing coefficients listed in the Russian Tax Code.

According to the current legislation, tax rates for 2012-2014 are the following:

RUB/ton	2012	2013	2014
Gazprom	509	582	622
Other natural gas producers	251	265	278

The new tax policy stipulates that the new tax rates, applicable from 1 July 2013, will be calculated using a specific formula that will allow withdrawal of 80% of the additional revenues from gas sales in Russia. Per Government representatives, beginning 1 July 2013 the MET rate will increase twice a year. The preliminary rates listed below have been agreed within the Government for now, but have not yet been approved by the Parliament:

RUB/ton	2013		2014		2015	
	1st half	2nd half	1st half	2nd half	1st half	2nd half
Gazprom	582	679	717	859	886	1062
Other natural gas producers	265	445	456	726	726	1049

2) The Law signed in November 2011 also introduced a specific fixed MET rate for gas condensate instead of the ad valorem rate used previously. Condensate produced from various hydrocarbon deposits is now taxable based on the volume of production (in tons) rather than fair market value of produced condensate.

The new rates are summarized below:

RUB/ton	2012	2013	2014
Gas condensate producers	556	590	647

3) The Law signed in November 2011 also introduced certain tax benefits for oil extracted from sites located fully or partially in Tatarstan Republic and Bashkortostan Republic.

4) Changes were introduced to the application of the 0% MET rate, which came into force beginning 1 January 2012:

   a) The 0% tax rate could be applied for oil extracted from sites located fully or partially in the Black Sea and the Sea of Okhotsk, subject to meeting specific thresholds.

   b) The 0% tax rate could also be applied for the natural gas extracted in the Yamal peninsula and used solely for LNG production, provided certain thresholds are met.

Tanzania Budget 2012/13: Tax changes relevant to the upstream oil and gas industry

While the uncertainty with regard to the application of excise duty is now resolved, it remains unclear whether upstream development activities would also benefit from this exemption.

The Government laid its budget proposals before the Parliament of Tanzania on 14 June 2012. The tax changes proposed are piecemeal and do not deal with many of the critical tax issues affecting the upstream sector as it gears up for significant investment in gas development.

Removal of excise duty on fuel used by upstream oil and gas companies

Upstream oil and gas companies have welcomed a proposal that extends excise duty exemption to the fuel used by the upstream oil and gas companies for their exploration and prospecting activities. Fuel used by licensed oil and gas companies was exempt from fuel levy in last year's budget. This generated speculation whether it was the intention of the Government to extend the exemption to excise duty as well and whether it would also apply to development activities. While the uncertainty with regard to the application of excise duty is now resolved, it remains unclear whether upstream development activities would also benefit from this exemption.

Despite the introduction of the exemption from fuel levy in last year's budget, we are not aware of any oil and gas company that has been able to utilize this incentive in the past financial year. Navigating the Government bureaucracy involved in securing the relevant Government Orders has proved a tall order. Therefore, there is the risk that this incentive may never be utilized as intended unless the bureaucracy is scaled down.

Removal of the VAT exemption on capital goods

Capital goods imported or purchased locally have previously been entitled to complete remission from VAT. It is now proposed that VAT at the rate of 9.9% will be paid on these capital goods. While this change does not directly affect the capital goods imported or purchased by licensed oil and gas companies (because of separate relief available to them), it will affect their subcontractors who do not have this exemption.

While the VAT payable on these capital goods can be claimed as input VAT under general principles, there are usually delays in obtaining tax refunds from tax authorities in case the purchaser/importer does not have sufficient output VAT to offset the credit. Inevitably, incremental costs resulting from delays in refunds to subcontractors will be passed on to the oil and gas companies.

Alternative minimum tax

The Government proposes to tax resident companies which have "a perpetual (sic) unrelieved loss for three consecutive years of income." (Why three years is viewed as perpetuity in Tanzania has never been clear.) The tax payable would be equivalent to 0.3% of the turnover of the third year. This tax has previously applied if the tax losses were attributable to tax incentives, such as accelerated depreciation available to some projects. With this proposal, all companies in a tax loss position may be liable for this alternative minimum tax.

Unless this proposal is qualified, it will affect the oil and gas companies at the commencement of hydrocarbon production. Considering the heavy capital investment required in this sector, it may take much longer than three years for projects to get to a tax paying position. Thus, this may affect the project economics of some of the upstream projects proposed to be undertaken.

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Talk to us

For additional information regarding global oil and gas resources, please visit **www.deloitte.com/oilandgas.**

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Designed and produced by The Creative Studio at Deloitte, London. 20286AA