Chapter 3 – Oil and gas industry

Extracting VAT from the oil and gas supply chain – who will bear the burden?
The oil and gas sector remains an important and significant part of each of the Gulf states. Businesses in the sector include large national oil companies and their associated entities, international oil companies with local operations (or trading in the area) – both in ‘upstream’ exploration and production activities and ‘downstream’ marketing activities, and service companies providing specialist resources and expertise to the sector. The introduction of VAT will have differing impacts for each type of industry participant.

Many in the sector anticipate that there may be a VAT relief applying to the oil and gas sector in some form – but even if this is the case, VAT is still anticipated to have an impact on all businesses. We explain below some common avenues for VAT relief applied on oil and gas activities internationally, and how these affect businesses across the supply chain. We explore the effect of VAT on cash flow – which looks to be an important issue across the sector – and look at some complexities of international operations. Finally, we explore two practical issues for companies in the upstream sector.

Potential avenues for VAT relief in the sector

Whilst the fall of oil prices has had a significant effect on the sector, oil and gas remains an important industry in each of the GCC states. Many expect that governments will not apply VAT across the entire sector, but will instead provide some form of relief (such as an exemption or zero-rate, for example) to lessen the burden of companies working in the sector.

Even if a VAT relief of some form does apply, this is unlikely to mean that VAT will have no effect on industry participants. Industry participants should be careful to understand any special rules that may apply; there are varying potential forms of relief which may have significantly different financial and operational implications. Based on international models, some of the potential treatments and their implications are explored below.

a. The standard position – VAT is charged on all transactions (taking place within the territory)

Many jurisdictions do not apply any special VAT treatment to upstream or downstream activities: VAT is in theory charged at the standard rate on sales of products and on services provided to oil companies. Despite this, in practice the international nature of the industry – both for extraction activities and sales of crude/product - often result in VAT not being applied under standard VAT rules. For example, a zero rate generally applies for products exported outside of a country, and exploration activities outside of a country’s VAT territory.

Applying VAT in this way is conceptually straightforward – but businesses must deal with international complexities of their operations (discussed further below), and additional cash flow requirements where VAT does arise in the supply chain. Most European jurisdictions follow this model.

b. A zero-rate applies to sales of certain extracted products, or more widely across the sector

Some countries apply a specific zero percent rate to sales of certain products in the sector (such as South Africa). For the supplier of zero-rated goods, this preserves their eligibility to claim an input tax credit for VAT incurred on their purchases, whilst no VAT needs be charged on sales. For this reason a zero rate is often viewed as a favorable position for these suppliers. Businesses making predominantly zero-rated supplies must however anticipate cash flow effects of
paying VAT to suppliers – values of which can often be significant for capital and operational expenditure used in the sector - and seeking VAT refunds from authorities.

The scope of any zero rate must be carefully considered. It is uncommon for a specific VAT relief to apply to domestic consumption of oil and gas. A distinction may therefore exist to restrict the zero rate to certain products or certain upstream activities. Businesses must carefully examine to what extent they are covered by any such relief.

c. A sector-wide exemption applies to specified oil and gas companies
A different type of VAT relief involves providing full exemption from VAT for companies operating in the oil and gas sector. Unlike the standard VAT exemption, which results in a restriction to VAT recovery, a full sector exemption as applied in some countries – particularly in Africa – allows oil and gas companies to not have VAT charged on their purchases. Often, this requires oil and gas companies to provide certificates to eligible suppliers to allow purchases without VAT. The certification process introduces additional administrative process and tax authority scrutiny to the supply chain. Improper certification can result in VAT being suffered in the supply chain, despite a sector exemption applying in theory.

Cash flow effects will be a key consideration in the sector
Whether one of the forms of sector relief described above applies or not, the cash flow implications of VAT need to be considered and planned upfront by all businesses working in the sector. Businesses making predominantly zero-rated or non-VAT liable supplies (e.g. under a VAT relief sector, or making sales for export) can expect to be in a regular VAT refund position, as credits for VAT on purchases will exceed VAT collected on sales. Even at a 5% rate, the impact of VAT will be significant for large commodity transactions and on capital expenditure. The timeframes for monetizing VAT receivable balances will depend on individual tax authority practices; will a taxpayer need to file a refund claim with supporting documentation, or will there be a standard timeframe allowed for authorities to verify or audit a VAT repayable position?

International supply chains bring complexity
Oil and gas companies have traditionally faced challenges in understanding and managing VAT obligations across international supply chains. The sale and purchase of crude and refined products gives a technical VAT obligation in the country where each transaction takes place. This can often result in unexpected VAT registration requirements or obligations to charge VAT where products are purchased and sold in overseas jurisdictions. Businesses must ensure they understand the VAT landscape and their obligations in any country where they have operations, and also in any countries where they transact. 

The cash flow implications of VAT need to be considered and planned upfront by all businesses working in the sector. Businesses making predominantly zero-rated supplies or supplies not subject to VAT can expect to be in a regular VAT refund position, as credits for VAT on purchases will exceed VAT collected on sales.
Whilst the concept of a zero rate for exported products in international practice generally reduces VAT costs for international movements of products or equipment, exporters must take care to collect and maintain commercial documentation to support zero-rating in the case of tax authority scrutiny. This process should be sufficiently robust to be able to have timely access to documents, even where another party (such as a freight agent or a customer) is responsible for carrying out the export formalities.

The VAT treatment of cost-sharing arrangements can often be unclear where a charge is made for a share in a bundle of costs

**Exploration phase – recovery and registration**
The oil and gas lifecycle may involve a long period of exploration and upfront investment until the asset (e.g. the oil or gas field) is in production phase - and first oil or gas is extracted. Until this time, the business is unlikely to make any supplies from that asset which would give a corresponding right to VAT registration or recovery of VAT on costs. Internationally, many jurisdictions allow businesses to be VAT registered, and to recover VAT incurred during these preliminary phases – otherwise, VAT incurred could form an additional irrecoverable cost and discourage investment in future projects. Ultimately, the VAT recovery position during this phase is likely to be a matter dependent on the specific rules in each country. If an upfront registration is not possible in a particular country (and this was certainly an issue in Malaysia when they introduced VAT), then businesses should explore what steps may be possible to ensure exploration and development costs are incurred by a company (or group) that is able to recover the VAT. In any case, forecasts for projects may need to include contingencies for irrecoverable VAT.

**Cost sharing in joint venture arrangements**
Many exploration projects are carried out as joint venture agreements, with multiple entities holding interests in the eventual production, and contributing their share in the development and operating costs of the projects. The sharing of costs between entities in this way (whether within a group or between third parties) is likely to be viewed as a set of separate transactions on which VAT should be charged, unless an exemption applies. The VAT treatment of cost-sharing arrangements can often be unclear where a charge is made for a share in a bundle of costs; even when a majority of costs might not be liable for VAT in nature (e.g. work carried out on an offshore rig outside the VAT territory), the VAT treatment for the bundle of services may revert to the default ‘taxable’ position. Upstream companies involved in joint venture agreements should review their contractual position and ensure that the agreements in place remain fit for purpose upon the introduction of VAT.

**Conclusions**
The oil and gas sector has a number of complexities – and the introduction of VAT across the GCC will doubtless add extra considerations for businesses across the supply chain. Whilst VAT is not intended to be an overall cost to businesses, it is almost certain that industry participants will feel a cash flow effect and will be required to comply with additional administrative obligations. Practically, VAT inefficiencies may result in a cost being borne at some part in the supply chain. Upstream and downstream businesses should examine their operations and existing arrangements to determine how VAT may affect them, and to ensure they are ready for the new world of VAT.
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