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How far is too far? The case of the UK corporation Tax

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Introduction

The recent credit crunch has taken its toll on the world economy and the position in UK has been no less different in the past few years. Oil & Gas UK[1] has estimated that had it not been the revenue of £ 12.9 billion pounds coming from the UK Hydrocarbon industry's Corporation Tax (CT) in 2008 alone, Britain's £44 billion worth of (BOP) deficit would have doubled to nearly £84 billion due to Britain's heavy dependency on imported fuel[2]. It is noteworthy that the black gold of the North Sea has contributed £271 billion in UK tax revenues for the past four decades and the payment of taxes by the same currently accounts for a third of UK's total corporation tax revenue. So far 2010 has not been a good year for an increase in oil prices and a slump again below 85$

[1] Oil and Gas UK (2010) Economics, Energy Policy and Gas available at http://www.oilandgasuk.co.uk/economics.cfm
[2] Ibid

per barrel for the same has been predicted as recently as April 2010[3]. If this drop materializes and continues into the future the UKCS oil industry will be bearing the burden of a high RFCT rate and low oil prices, which are currently the main reasons behind its dwindling productivity and reduced profitability for its major players as well as a major disincentive for new entrants[4].

Keeping in mind these raw facts above**,** while it is possible to say that the UK legal regime pertaining to Oil and Gas is perhaps one of the most sophisticated ones in the world, the same cannot be said of the UK Oil and gas taxation regime. This is simple because the rules pertaining to corporation tax in particular and the fiscal regime in general are often viewed by many as "distortions" of how the same would relate to the CT liabilities[5] other industries with in the same jurisdiction[6]. These rules for the past many decades or so have remained in a state of flux and this has led many to remark[7] that such a frequent and deliberate manipulation of a fiscal regime by a government to suit its own revenue enhancement needs, is certainly not conducive to the ends of attracting and maintaining investing incentives with in the UKCS. The most recent changes coming after the Finance Act 2009 have not changed things much in terms of these distortions, except the rearrangement of a few politically correct terminologies[8]. Infact the way the UK fiscal policy has manipulated and named and renamed what is now known as the "RFCT" or "CT" over the last two decades, reminds one of Alice's flustered response to the Caterpillar in Lewis Carroll's masterpiece, "Alice in the Wonderland", who when asked who she really is, gives the following reply, *"I — I hardly know, sir, just at present — at least I know who I was when I got up this morning, but I think I must have been changed several times since then.[9]'* Indeed if the CT as applicable to UKCS was an individual, this would be its exact response in an effort to identify itself.

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[3] Ablo Gorondi. "Oil drops below $85 as stocks slump, dollar gains." AP Worldstream. 2010. HighBeam Research. 25 Apr. 2010 <http://www.highbeam.com>.
[4] "Lib Dems divided on oil tax profits." Press and Journal, The Aberdeen (UK). Northcliffe Electronic Publishing. 2008. HighBeam Research. 25 Apr. 2010 <http://www.highbeam.com>.
[5] The most recent position of the ordinary CT rules as they apply to non-hydrocarbon concerns can be discerned from the Corporation Tax Act 2009 and the Capital Allowances Act 2001.
[6] James May, "Tax regime will send oil and gas advantages up in flames", 2010 Sweet and Maxwell, C.A. Mag. 2002, 106(1153), 7
[7] See for example the views of Alex Kemp, "The impact of the 2002 tax changes on the UK continental shelf" and more recently Emre Usenmez (2010)
[8] For a detailed analysis of the same see Emre Usenmez (2010) and DECC (2009). A detailed discussion of the expected impact of these changes is undertaken later in the essay.
[9] Alice in the Wonderland (1865) Chapter 5 - Advice from a Caterpillar

Summary of the current CT/RFCT regime as it stands today

Before analyzing further the effect of these "special" corporation tax rules which apply exclusively to the UK hydrocarbon industry, it would be expedient to give a cursory glance to the UKCS Corporation tax regime as it has developed since 1965.Since a detailed discussion of PRT (Petroleum Revenue Tax) is beyond the scope of this essay, the section below will centre solely on how the UK Hydrocarbon Tax Regime in general and the Corporation Tax (CT and RFCT) regime in particular has evolved. This will be to aid the observation how these rules are quite different from the ordinary rules of Corporate Taxation as they apply to UK companies. The purpose of restating these chronological events therewith is not to give a straightforward, ad *nauseum* restatement of the UK Hydrocarbon law of taxation but to aid the subsequent analysis of the so called distortions and whether they have infact "gone too far" in terms of affecting the economic potential of the UKCS especially after the Finance Act 2009.

In addition to the above, for the purposes of this discussion it should also be remembered that currently there are two types of direct taxes being paid by Oil and Gas companies in the UK; these are the Ring Fence Corporation Tax (RFCT) and Petroleum Revenue Tax (PRT)[10]. After legislative changes in 1993 only the companies which had their fields approved before 15 March that year are liable to PRT.After that date, the companies only have to pay a Corporation Tax (CT) which seems simple enough. But the way in which this CT has been engineered to suit the BOP (Balance of Payment) needs of the UK government, makes the whole corporation tax regime as applicable to the UK oil and gas industry very much different from than the ordinary rules of CT as they apply to non-hydrocarbon extracting business concerns within the UK. While any royalty[11] and PRT[12] are deductible as an expense against CT and chargeable profits, the "Ring-fence Methodology" is what essentially makes the UK Hydrocarbon CT regime unique and much different from its North Sea

[10] United Kingdom Inland Revenue, Department of Trade and Industry, "Taxation of UK Oil Production" available from http://www.inlandrevenue.gov.uk/international/ns-Fiscal2.htm (accessed April 5, 2010)

[11] Royalties are administered by the DTI @ 12.5 per cent of the value of production, less the cost of initial transportation and treatment, for fields approved before 1 April 1982. Royalties payable are deductible against profits chargeable to PRT and corporation tax, Royalties were abolished from 1 January 2003

[12] Where applicable after 1993

Neighbor, Norway.[13]The rationale[14] given for the existence of the Ring-fence Corporation Tax (RFCT) is basically that it is in place to prevent[15] profits from oil and gas production being offset by losses transferred from the companies' other non-hydrocarbon extraction related, activities outside the North Sea[16]. This way of applying CT rules upon the Oil and Gas industry is clearly a distortion of the ordinary CT rules and one, rather simplistic way of understanding it from an economic point of view would be the government's needs for revenue maximization[17]. However as the subsequent discussion demonstrates, this should certainly not be a priority of a government faced with a "mature province" which needs to give out more CT incentives now than ever to remain a competitive global hydrocarbon extraction destination. It is also worth noting that unlike Ordinary UK business concerns and companies, Oil and Gas companies cannot set off Advance Corporation Tax accounted for on dividends paid by associated UK resident companies, upon their ring fenced North Sea tax liabilities, which is again a significant variation of the ordinary rules of CT[18].

The year 2008-9 has seen a further simplification of the Oil and Gas corporation tax regime. Many as merely cosmetic and a play on labeling and semantics have viewed this[19]. In essence the abolition of PRT and royalty was replaced with much more stringent and demanding CT rates compounded by the "ring-fence" and "supplementary charge" concepts[20]. Thus merely changing the terminology of the allegedly fiscal punishment being inflicted on the ailing UKCS industry is still viewed by commentators as not having discontinued the distorted pathology of the CT (which is

[13] A useful comparison of the UK and Norway taxation regimes and what the UK could possibly learn from its North Sea neighbor, Norway's tax regime has been taken up by
Mark Thomas Hill, "The British North Sea: the importance of and factors affecting tax revenue from oil production" (MA Thesis Brigham Young Univ.; 2003).

[14] Parliamentary Debate (2002): Hansard, HC, Vol.492, Pt 70, col.178 (accessed April 5, 2010)

[15] According to the HMRC this is " to prevent companies manipulating their levels of borrowing between ring fence and non-ring fence activities to minimize the impact of the SC". HM Revenue & Customs, *International--The North Sea Fiscal Regime,* 2008, para.7.4

[16] A new Exploration Expenditure Supplement (EES) was introduced for exploration and appraisal expenditure on or after 1 January 2004 to cover all ring fence expenditure (RFES) incurred by companies who have no CT liability and thus allow them to enhance the value of the relief 6 per cent a year for a maximum of 6 years. However since January 1, 2006, EES was replaced with Ring Fence Expenditure Supplement (RFES), widening " the scope to include all North Sea expenditure which cannot be relieved against North Sea profits" (HM Treasury, The North Sea Fiscal Regime, 2007, para.2.15)

[17] Oladiran Ajayi, Resource taxation as a tool for development (2009) I.E.L.R. 57

[18] See Finance Act 2002 (c.23) Pt 3: Income Tax, Corporation Tax and Capital Gains Tax, Chapter 1: Charge and Rate Bands, para.91 (1), under " Supplementary Charge in respect of ring fence trades".

[19] See Emre Usenmez (2010) and the Commentary by John Evans (2007)

[20] Ibid.

now dressed up as the 20% SC and the RFCT) for the economic future of the UKCS.The corporation tax payable post 2008 is the RFCT[21] (The Ring Fence Corporate Tax) which is supposedly the same as the ordinary corporation tax with the "lacuna" being that it has to be "ring fenced" as a separate trade to avoid losses from other company activities reducing government take. Thus now (2008 onwards) UKCS CT has been " set separately from the headline corporation tax rate applicable outside of the ring fence[22]" at the rate of 30%. Since the RFCT is peculiar to hydrocarbon activities only, The HMRC has further clarified that "… trading losses arising from such activities are relievable for corporation tax in the same way as losses from other trading activities"[23]. This would imply that such losses (such as those arising as a consequence of decommissioning) could be set off against other profits[24]. It is important to however remember that this is where the much-promised similarity ends with the ordinary CT regime. This is because in the context of RFCT now all capital expenditure incurred within a given ring fence, inclusive of decommissioning expenses qualify for 100% first year allowances (FYAs) which basically means that costs can be written off for tax purposes in the accounting period in which the expenditure is incurred (unless these are long-life assets in which case they only qualify for 24% FYA)[25].

In addition to the above it is worth noting here that almost eight years ago when the supplementary charge (SC) was being imposed upon the UKCS hydrocarbon activities in 2002, there was little governmental concern shown for the new entrants in the industry or even for the then over-burdened industry players. The Supplementary Charge, which was introduced by the Finance Act 2002[26] in line with the Government Proposals for receiving a " fair return" for the taxpayer, raised quite a few eyebrows amongst the stakeholders in the industry, despite the high oil prices at that time. Many commentators regarded this as the final nail in the coffin of the remaining trust the

[21] DECC, The UK Continental Shelf Tax Regime, " Ring Fence Corporation Tax". https://www.og.decc.gov.uk/upstream/taxation/index.htm [Accessed April 15, 2010]

[22] HM Treasury, The North Sea Fiscal Regime: a discussion paper, 2007, para.2.10

[23] HM Revenue & Customs, International--The North Sea Fiscal Regime, 2008, para.1.11 under " Ring fence corporation tax (RFCT) as quoted by Emre Usenmez (2010)

[24] Ibid.

[25] HM Revenue & Customs, International--The North Sea Fiscal Regime, 2008, particularly paras 6.1 to 6.14

[26] The Ring Fence Charge (Supplementary and a part of CT): since 2002 companies that operate in the North Sea have been subject to a supplementary charge on their profits in respect of ring fence trades, at a rate of 10 per cent. Which was raised in 2005 to 20% on profits earned on or after 1 January 2006. The supplementary charge is assessed on the basis of ring fence profits as computed for corporation tax, (but without any deduction for financing costs). This also means that royalties or PRT can be deducted against the same as chargeable profits as they are for corporation tax.

industry had in the government's fiscal wisdom[27]. In 2002, the following statement came from a parliamentary speech while discussing the introduction of the increased RFCT and the Supplementary Charge.

" It is clear that oil companies are generating excess profits, and ours is the only major oil-exporting economy that does not have a special regime to reflect that …Companies that invest in the North Sea will receive full and immediate [100 per cent] relief against any tax liability, while those which do not do so will rightly pay a higher share of corporation tax, together with a supplementary charge."[28]

To make things more difficult and unpredictable, this supplementary charge was subsequently increased in the Finance Act 2006 to 20%, an increase which led to an outcry by the industry and businesses alike despite the ongoing increase in oil prices at that point and it came as no surprise much later when the SC's contribution to CT increased from 25% in 2004 to 41% between the years 2006-2009[29].There was a strong protest at that time based on the fact that due to the added burden of the PRT on older and larger fields this would translate into a potential tax hike of three-fourth of the current CT rate then which later turned out to be true as mentioned above[30]. It is easy to simplistically argue that the oil and gas producers get their fair share of profits from the increase in global oil process but the recent years have seen volatile fluctuations in these prices as well.

Almost eight years later it seems that the UK Government has learnt its lesson[31]. The hard way that is. After much evidence that the past few years have been the least productive years of the North Sea[32] alongwith a marked exodus of the Oil companies to lucrative exploration destinations elsewhere in the world, the changing tone of the UKCS hydrocarbon tax policy was pretty much

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[27] See James May, "Tax regime will send oil and gas advantages up in flames", (and) Carole Nakhle, "Opinions on the UK North Sea Petroleum Fiscal Regime: Preferences Revealed",

[28] Hansard, HC, Vol.385, Pt 144; Ruth Kelly, cols 359, 360, 361 (May 9, 2002) quoted in an article by Emre Usenmez (2010).

[29] Emre Usenmez (2010) The stability of the UK tax regime for offshore oil and gas: positive developments and potential threats

[30] See the views of John H. Bartlett, "Taxing North Sea Oil", Phil Greatrex , "United Kingdom - Finance - 2005 Budget proposals", 2005 and Philip Greatrex, "United Kingdom: tax - regulation - UK Pre-Budget report".

[31] Alexander Kemp and Linda Stephen, " The Prospects for Activity in the UKCS to 2035: the 2008 Perspective".

[32] Ibid

evident from the consultations leading up to the 2009 Finance Act[33]. Upon analysis this Act seems to be a hastened effort to attract investment now that the major players seem to be leaving the field, much financially distraught by the constantly fluctuating oil and gas corporation tax regime.[34]The fact that the remaining North Sea oil has become more difficult and more expensive to extract and security of energy supply should be a more profound concern for the government than the collection of revenue.[35]

For the sake of argument there are two points to make here indeed. The view which will be taken by the "green" party, environmentalists and the conservationists is that such a fiscally punitive tax regime is ever so conducive to helping slow down the rapidly diminishing oil potential of the UKCS.The view can possibly justify the much distorted UKCS CT structure in the sense that the increasing taxes will address the negative externality of the misuse of the UKCS by these E&P companies. Such a view would mandate the introduction of increased CT reflecting a kind of "carbon tax" on the industry as well to address the environmental externalities and slow down oil depletion in the UKCS[36]. However since the UK has not agreed to participate in the EU Taxation Regime, the Emissions Trading Scheme has been utilized for the same purpose[37]. This would seem fair in the light of the fact that most of the new fields commissioned after the nineties are not liable to PRT or even royalties anymore, unlike other hydrocarbon tax regimes of the world[38]. This does not however mean that the UK government is giving away its oil to companies for free as the constantly changing face of the CT over the past two decades has demonstrated. On the other hand the factum of the UK's BOP being in dire straits without enough domestic oil production is oft

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[33] See DECC (2009) Changes to the North Sea fiscal regime included in Budget 2009: HM Treasury (2009), Chancellor of the Exchequer's Budget statement, April 22, 2009; HM Revenue & Customs (2009), International--The North Sea Fiscal Regime: A Guide to UK and UK Continental Shelf: HM Treasury (2007), Securing a sustainable future: a consultation on the North Sea Fiscal Regime, December 2007,

[34] Emre Usenmez (2010) See also Oil & Gas UK, Activity Survey 2008, February 2009, p.2; see http://www.ukooa.co.uk/issues/economic/activitysurvey08.pdf (Accessed April 15, 2010)

[35] Alexander G. Kemp and Linda Stephen, " The Budget 2009 Tax Proposals and Activity in the UK Continental Shelf (UKCS)"

[36] Ian Bailey (2010)

[37] It should be noted however that due to UK's commitments to the EU Emissions Trading Scheme (EU ETS) the costs associated with the purchase or trading of EU ETS allowances in connection with the requirement to meet emissions requirements of ring fence installations are deductible as costs of the ring fence trade and are thus very much relevant to CT and SC calculations of Oil and Gas concerns. Likewise the income associated with the sale of EU ETS allowances allocated to installations within the ring fence is taxable within the RFCT ring fence (Ian Bailey, 2010).

[38] Ian Bailey (2010)

ignored when an argument is given to make the current UKCS CT rate "greener" in line with the EU emissions policy[39].

An evaluation of the Finance Act 2009

The most recent CT relevant legislative changes have been seen in the form of the Finance Act 2009 which demonstrate a somewhat sheepish yet lukewarm realization on behalf of the UK government that CT rules which are as unpredictable as the London weather are the least conducive for the health and wealth of the UKCS.Although by the removal of royalties and the PRT it would seem that the distortions to the ordinary CT rules have been removed, one only has to take a second glance at the small print pertaining to the accounting periods, the "supplementary" extras and of course the "Ring Fence" to realize that such distortions are very much there. The Finance Act 2009 seemed promising when it came out last year with its field allowance incentives for smaller fields with heavy oil and high-pressure sections which are a neglected bit of the UKCS in terms of new investment[40]. Thus the ICTA (Income and Corporation Taxes Act 1988) was accordingly amended by the Finance Act 2009 to reduce supplementary charges for fields qualifying under the criteria for the same, as incurred after April 2009.This measure was however criticized for being "too little, too late" by Shell and BP and in a statement given to the House of Commons Energy and Climate Change Committee[41] it was stated by both companies that the new allowance system was a welcome step but too limited to certain fields in terms of bringing CT and SC relief and would do little to preserve UK's fast declining competitiveness with the global Oil market. This was because this so called "field allowance" was setting too precise and high a threshold for a field to qualify for such an allowance at all[42].

The reason this was so negatively viewed by the UKCS industry is because currently North Sea production and investment is at a point of stagnation because of the CT distortions and rapid changes over the last few years. The halted investment in Brownfield's and the West of Shetland

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[39] Ibid.

[40] HM Revenue & Customs, International--The North Sea Fiscal Regime: A Guide to UK and UK Continental Shelf: Oil and Gas Taxation, January 2008, para.1.11; see http://www.hmrc.gov.uk/international/ns-fiscal3.htm [Accessed April 20, 2010].

[41] Energy and Climate Change Committee, UK offshore oil and gas, First Report of Session 2008-09, Vol.II: Oral and Written Evidence, June 17, 2009, Ev.55, para.9 as mentioned by Emre Usenmez (2010).

[42] See the article by Emre Usenmez (2010)

are only one example of the revenue loss being faced by the UKCS with each passing day due to the complicated CT regime and high operational costs. The fact that the RFCT was changed thrice during the period of 2004-2008 and that the year 2002 saw yet another manipulation of the CT in the form of the SC, has clearly brought to light the dangers of an unpredictable tax regime where as the trust of the Oil and Gas industry is more than lost. It would seem pointless to place trust in a CT regime which cannot be relied upon for its stability to enable them to have enough incentives for sticking to an ailing UKCS about to lose its vitality and potential in less than half a century. Emre Usenmez [43] has discussed how many major industry players essentially viewed the SC as a "breach of faith" by the government when they believed that their voices were actually being heard and taken into account through the OGTIF and PILOT consultation forums, and such a step was taken, allegedly, without industry consultation[44]

UKCS Corporation taxation Policy: a few conclusions

Coming back to the main question: Has this distorted and very much manipulated CT actually helped Britain at all? The answer is 'Yes' in terms of increased revenue but a dismal 'No' in terms of encouraging the development potential of the UKCS.Thus the author would agree with the statement in question that such a distortion has gone "too far" by making the enhancement of revenue, a priority for the UK government over encouraging industry investment. Truly the UKCS oil and gas industry has often been dubbed as the "Cash Cow" of the British economy, heavily milked for revenue by the HM treasury for almost three decades since North Sea Struck gold in the seventies and has played a phenomenal role in addressing Britain's balance of payment deficits year after year since then. However the getting "fair return for the tax payer"[45] mantra of the UK government seems like a rhetoric now that the CT and RFCT system of UKCS does not reflect effectiveness in balancing the goal of encouraging production with that of securing adequate revenue. While distortions created by such taxes can be tolerable to the extent of preventing environmental externalities through carbon emissions, it is time to rethink such policies when they start damaging a jurisdiction's credibility for having a stable fiscal framework and a reliable legal

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[43] (2010) The stability of the UK tax regime for offshore oil and gas: positive developments and potential threats
[44] John H. Bartlett, "Taxing North Sea Oil", 2002
[45] Refer back to the Parliamentary Debate (2002): Hansard, HC, Vol.492, Pt 70, col.178 (accessed April 5, 2010)

regime to support it. While the UK government could afford to be oblivious to these goals in 1973 when the North Sea was oozing with production potential, it is time to rethink CT incentives for new entrants and current business entities, in order to prevent the UKCS from becoming one of the most expensive, least productive and thus least competitive, global hydrocarbon sources of the future. The discussion above has seen that till date the UK government has only taken short term CT cuts without compromising its take of the oil profits and goals of revenue maximization. While the 2009 Finance Act shows a softening of this approach, the already reluctant current industry players might not be convinced to keep playing the field in the UKCS for too long.

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