

## Pre-Budget Report 2008

### Implications for International Exploration & Production Companies

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Most of the 2008 Pre Budget Report (PBR) headlines have focused on the reduction in the VAT rate and the stimulus to consumer spending in the UK. However, from an international business perspective the PBR brings a welcome resolution to over two years of debate on aspects of the UK taxation of foreign profits and represents a significant change to how the UK taxes international activity.

#### Key changes announced

The reform package announced today will introduce an exemption for foreign dividends (subject to certain restrictions) received by large and medium sized businesses. This will be accompanied by the abolition of the outdated Treasury Consent requirements and their replacement with more limited post-transaction reporting<sup>1</sup>. These two reforms are the 'good news'. The 'bad news' is as follows:

- the introduction of a worldwide cap on the amount of interest which can be deducted for tax purposes in the UK;
- an extension to the current anti-avoidance rules for loan relationships; and
- the restriction of some of the current exemptions under the Controlled Foreign Company (CFC) rules.

Draft legislation is expected to be published in December 2008 for consultation in order to implement these reforms in Finance Bill 2009. We do not therefore have the full details which will become clearer over the coming weeks.

In addition the Chancellor has announced a further round of consultation on the future of the UK's CFC rules which for some businesses have been the most controversial part of the consultation process to date. The timing of this further round of consultation remains unclear.

#### Context for E&P companies

For many years the UK has had a thriving international oil and gas business which has invested in overseas E&P projects. In particular, as the UK North Sea has matured as an oil and gas province, both the UK based majors and independents have increasingly focused on international investments often in countries that have Production Sharing Contract (PSC) arrangements for oil extraction activities.

In addition, the number of UK headquartered E&P groups has multiplied in recent years as the London Stock Exchange has become the market of choice for such businesses.

Often, such listings have involved companies with limited previous connections with the UK, and whilst the Stock Exchange does not require a UK incorporated and therefore UK tax resident, holding company, our experience is that this is generally the preferred structure as it is perceived as being more attractive to potential investors.

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<sup>1</sup> For background, consent has previously been required from HM Treasury prior to effecting a transaction whereby a non-UK resident company controlled by a UK resident company issues or transfers shares or debt instruments.

Additionally, if the majority of a listed company's board of directors are UK tax resident, then the company may in any case become UK tax resident by virtue of having central management and control in the UK, even if it is not UK incorporated.

### **Initial assessment of the impact of the PBR for international E&P companies**

Our initial assessment is that the majority of E&P companies with a UK taxable presence will benefit from the proposed reforms. Certainly the introduction of a dividend exemption is particularly welcome for E&P groups many of whom currently experience difficulties in claiming credit for overseas taxes which may not fall within the HM Revenue & Customs (HMRC) definition of a creditable tax. In addition the exemption will greatly reduce the compliance burden imposed on companies, removing the need for detailed Double Tax Relief (DTR) calculations especially where dividends are paid up through a chain of companies.

The detail of the worldwide cap on interest and changes to the CFC exemptions will need to be considered by each group. However it is not anticipated that these changes will give rise to significant issues for E&P companies given the usual structure of a UK parent providing funds to overseas subsidiaries which are likely either to be subject to a higher rate of tax than in the UK (and hence not be a CFC) or should continue to benefit from the exempt activities test.

The proposed reforms also increase the relative attractiveness of the UK corporation tax system for holding companies. Taken together with the UK's chargeable gains exemption for 'substantial shareholdings', the absence of a UK dividend withholding tax, the UK's extensive treaty network (particularly with emerging markets) and the availability of interest relief on borrowings, the proposed reform is likely to make the UK a more attractive holding location for E&P groups.

Detail of the PBR reforms follows below and additional commentary can be found at Deloitte's dedicated budget website. [www.ukbudget.com](http://www.ukbudget.com)

### **Proposed foreign dividend exemption**

Under the current system, a UK tax resident company is subject to corporation tax on its worldwide profits including dividends from overseas subsidiaries at a rate of 28%, but with a potential credit for any overseas tax suffered.

If the rate of overseas tax exceeds the UK rate, then in principle this DTR credit may mean that no additional UK tax arises. However, in practice there are a number of reasons why the DTR mechanism may not eliminate the exposure to additional UK tax for E&P groups as follows:

- If the level of overseas 'tax' suffered is less than the UK rate. The key issue in this respect is whether the overseas government take in respect of E&P activities is regarded as creditable tax by HMRC. For this to be the case it needs to be a profits based income tax so royalties and profit oil allocated to the host government will not normally qualify.
- It can often be difficult to evidence that tax has been borne by the overseas company on its E&P activities. In particular 'tax paid' PSC arrangements often exist whereby this tax liability is settled on a company's behalf by the overseas state oil company or other government body out of their share of Profit Oil. In particular, as the tax is still borne by the E&P group's subsidiary DTR is still often available, although this depends on the detailed contractual mechanism in the specific PSC. However, whilst the PSC terms normally provide that the oil company is to submit tax returns and that assessments/tax receipts will be issued for payments made in this manner, such evidence of payment is often not forthcoming in practice which can make claiming DTR difficult.
- Even if the rate of overseas tax is higher than the UK rate, timing differences can arise such that dividends are paid before overseas taxes have been suffered. This might happen if the overseas country has a tax holiday for a period, or the level of overseas tax relief for development expenditure is very generous (100% relief is not unusual), so that it is many years before overseas tax arises.

Given the above, the replacement of the DTR system with a dividend exemption for large and medium sized businesses is a welcome reform for E&P businesses and will allow funds currently held overseas which have either borne a lower tax rate than the UK rate, or for which evidencing the foreign tax borne is difficult because of 'tax paid' PSC arrangements, to be repatriated to the UK either for return to shareholders, reduction of UK debt or expansion of activities elsewhere in the group without any risk of an additional UK tax burden.

The fact that the dividend exemption will be provided to companies for both participation and portfolio holdings of ordinary shares and most non-ordinary shares is particularly good news for E&P groups who often operate through joint ventures and strategic investments.

It is not yet clear from what date the reform will apply but we expect further details in the draft legislation which should be released in December 2008. Given that the reforms may be implemented as early as April 2009, businesses should consider whether it is advisable to defer a proposed dividend, where possible until the reform is implemented, in order to take advantage of the proposed exemption particularly where companies are currently adversely affected by the DTR system. Furthermore, any existing unrelieved foreign tax credits may now be effectively forfeited.

### **Proposed changes to Controlled Foreign Company (CFC) rules**

The current CFC rules apply to apportion profits from certain low tax overseas subsidiaries to their UK parent. The PBR announcements indicate that the Government has moved away from the previous proposal referred to as the 'Controlled Company' rules (which focused on mobile, or passive, income, rather than on the status of the company). Instead, the Government have confirmed that the new CFC system should not tax profits genuinely earned in overseas subsidiaries. This is stated to be consistent with a move towards a more territorial system of taxing which should not tax profits that are genuinely earned overseas.

This wider reform of the CFC rules (which was originally suggested as part of this reform package) has been deferred. This will still be taken forward but is not expected to be concluded in time for Finance Bill 2010, and therefore is unlikely to be effective for over two years.

However, the PBR does include the abolition of some of the current CFC exemptions available for offshore subsidiaries. The PBR announced the repeal of:

- The Acceptable Distribution Policy (ADP) exemption, which allows a CFC to be exempt if it distributes at least 90% of its profits back to the UK via a taxable dividend within 18 months of the end of the accounting period. The introduction of dividend exemption means this CFC exemption no longer makes sense and in fact, even if it were not abolished it simply would not be effective any more as the requirement for the dividend to be subject to UK tax would not be met under a dividend exemption system.
- The holding company tests contained within the exempt activities CFC exemption (subject to a 24 month transitional period to allow existing holding company structures to be unwound).

In general, we would not expect these changes to adversely affect many overseas E&P subsidiaries which are engaged in actual E&P activities as these should continue to benefit from the 'exempt activities' exclusion. However, we have increasingly seen HMRC challenge the CFC status of offshore tax haven companies which carry out E&P activities via a local branch, a structure which is common in the sector. The Motive Test exemption applies to such companies where tax considerations are not the main reasons that they exist, and HMRC have been increasingly reluctant to apply this test to E&P activities.

In addition, the removal of the holding company test may adversely affect multinational E&P groups to the extent that they have offshore sales or service companies or use offshore holding companies in low tax jurisdictions for cash pooling/financing within the same territory or as bid vehicles for corporate acquisitions.

This means that affected companies will need to consider whether any of the alternative CFC exemptions may be available to them. To the extent that an exemption is not available groups will need to consider whether to restructure or suffer a CFC apportionment which, even if it does not increase the total tax cost (because of relief for overseas taxes already suffered) will increase their compliance burden.

### **Other proposals**

The PBR also announced a range of other reforms which may be of interest to E&P companies including:

- The abolition of the requirement to make advance Treasury Consent applications. This will be replaced by a post-transaction reporting requirement and is subject to a materiality threshold to capture only higher value transactions above £100m. The current advance consent requirements are an area which often catches out groups that are new to the UK. Therefore, the move to a post transaction reporting system with a de minimis limit is a welcome change and will reduce compliance costs.
- The Report also announced the introduction of a worldwide debt cap. This will limit the amount of UK tax deductible interest available to a group by reference to the group's consolidated net external finance

costs. Details are still to be confirmed but it is thought that the new cap is only likely to affect E&P groups that have upstream loans to parent companies headquartered in the UK.

- An extension of the unallowable purpose rules for loan relationships to include schemes or arrangements.
- Groups operating through overseas branches of UK companies should note that the PBR did not comment on the possibility of a branch exemption from UK tax despite the clear link between the tax treatment of foreign dividends and of the overseas branches of UK companies. As many E&P groups hold their overseas assets through branches of UK subsidiaries they will want this matter addressed as soon as possible, and it is likely that representations will be made to address branch exemption as part of these reforms. Whilst we acknowledge this is an issue, any proposals to address this issue will have to sit within the wider CFC reform agenda. We will be monitoring this going forward.

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