Petroleum mining income tax regime

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Get the right tax advice on the NZ oil and gas tax regime!

At PwC we've got over 20 years' experience servicing the needs of petroleum exploration and production companies, oilfield services companies and associated businesses in New Zealand. What's more, we're the only global advisory firm with an office of industry experts in Taranaki, New Zealand's major petroleum producing region and the focus of most current exploration activity.

So we've got hands-on expertise to help you out. We'll provide you with the petroleum mining tax and accounting services you need - from arrival to eventual departure; covering your company, the assets it brings to New Zealand and the employees who come here.

We'll make sure you get the best advice. You'll have access to our team of acknowledged industry tax experts in upstream and downstream energy. And you'll get the benefit of our sophisticated systems to help you with cost effective accounting and tax compliance, GST and customs duties.

Before you start your exploration or production in New Zealand, talk to us. We'll make sure you're armed with the latest oil and gas tax information and set up your business so you benefit from the tax regime.

Overview

The New Zealand income tax rate for companies is 28% of taxable income. Taxable income is calculated after allowing for 'deductions' against assessable income.

The New Zealand petroleum mining income tax regime treats all income from petroleum mining activities as assessable income. However, the distinction between capital and revenue expenditure is largely disregarded. The petroleum mining tax rules apply a separate regime for amortising costs associated with petroleum assets. Broadly speaking, the regime provides for:

- immediate tax deductions for 'petroleum exploration expenditure'
- two methods for amortising 'petroleum development expenditure'
- immediate deductions for unamortised petroleum development expenditure in some circumstances.

Accordingly, the deductibility of petroleum mining expenditure depends on whether the relevant expenditure is classified as:

- petroleum exploration expenditure;
- petroleum development expenditure; or
- 'residual expenditure'.

Application of the regime

The petroleum mining tax regime generally applies to 'petroleum miners'. A petroleum miner is defined in the tax legislation as a person who undertakes petroleum mining operations in a permit area. The definition specifically excludes persons who undertake petroleum mining operations for consideration that is not in the form of, or contingent on:

- the production of petroleum from the permit area;
- profits from the production of petroleum from the permit area; or
- an interest or a right in the petroleum permit.

Effectively this generally means that the petroleum mining regime will only apply to entities that actually hold the petroleum permit and carry out the mining activities. The regime will generally not apply to those providing services to the permit holder.

Petroleum exploration expenditure

Petroleum exploration expenditure is deductible in the year it is incurred. There is no requirement that these costs be spread over the life of the petroleum activities.

Petroleum exploration expenditure is defined to include:

- exploratory well expenditure;
- prospecting expenditure; and
- expenditure to acquire an existing privilege, a prospecting permit for petroleum, or an exploration permit for petroleum.

The definition of petroleum exploration expenditure specifically excludes:

- deemed petroleum development expenditure (see below); and
- residual expenditure.

Petroleum development expenditure

Petroleum development expenditure is defined as expenditure directly concerned with a permit area and that relates to the planning, construction or acquisition of petroleum mining assets. Petroleum development expenditure specifically excludes:

- residual expenditure; and
- petroleum exploration expenditure.

Petroleum development expenditure is treated as deferred deductions for income tax purposes. Petroleum miners have the option of two methods for amortising petroleum development expenditure:

- costs may be spread on a straight-line basis over seven years, commencing from the date the costs were incurred; or
- the 'reserve depletion method' may be used.

The reserve depletion method of spreading petroleum development expenditure allows for petroleum development expenditure to be spread over the life of the development, based on units of production for the year and expected total production from the development.

An immediate deduction for unamortised petroleum development expenditure is generally available when:

- the relevant petroleum permit is relinquished; or
- the relevant petroleum mining asset is sold to a non-associated party.

Immediate deductions are also available for unamortised petroleum development expenditure relating to a well where:

- the well will never produce petroleum in commercial quantities and is abandoned; or
- if the petroleum miner is using the reserve depletion method of amortisation for the relevant permit, the well stops producing petroleum in commercial quantities and is abandoned.

Deemed petroleum development expenditure

Expenditure incurred in buying a petroleum mining asset at a time when either point below applies is deemed to be petroleum development expenditure:

- petroleum is being produced in commercial quantities on a continuing basis under the relevant permit; or
- an application for a petroleum mining permit has been made for the permit area.

This deeming provision overrides the usual petroleum exploration expenditure treatment for acquisition costs in relation to a prospecting or exploration permit.

Petroleum mining assets

A petroleum mining asset includes petroleum permits and assets that:

- are acquired for the purpose of:
  - developing a permit area for producing petroleum;
  - producing petroleum;
  - processing, storing, or transmitting petroleum before its dispatch to a buyer, consumer, processor, refinery or user;
  - removal or restoration operations; and
- have an estimated useful life that is dependent on, and no longer than, the remaining life of the permit; and
- are not land.

Exclusions from petroleum exploration and petroleum development expenditure

Residual expenditure is specifically excluded from the definition of both petroleum development expenditure and petroleum exploration expenditure. 'Residual expenditure' is defined in the tax legislation and generally includes expenses which are ordinarily deductible such as interest, rents and insurance premiums.

The definition of petroleum development expenditure also excludes expenditure that is deductible as incurred under provisions of the tax legislation that are outside the petroleum mining regime. A common example of this is feasibility expenditure. As a result, the petroleum mining provisions should not generally result in a tax outcome that is disadvantageous when compared to ordinary tax rules.

Exploratory well expenditure

Expenditure incurred in drilling an exploratory well is generally deductible when incurred. However, if the well is later used for commercial production, some of the expenditure previously deducted must be added back as taxable income in the year commercial production starts. This amount will then be treated as petroleum development expenditure and amortised.

Removal or restoration costs

A deduction can be claimed for expenditure incurred on removal or restoration operations. The expenditure must relate to the relinquishment of the relevant petroleum permit.

Generally, this deduction is allowed in the income year in which the expenditure is incurred. To the extent that this expenditure creates a tax loss for the income year, the expenditure may be allocated to previous income years. This backwards spreading of the expenditure may necessitate amendments to prior year income tax returns.

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Sale of assets

Any amounts derived from the disposal of exploratory material or a petroleum mining asset are taxable income of the petroleum miner. Exploratory material includes anything acquired as a result of exploratory well expenditure or prospecting expenditure. The capital / revenue distinction which applies to asset sales under general tax rules is disregarded in the petroleum mining context.

Generally, a deduction will be allowed for any unamortised petroleum development expenditure. However, special rules apply where the assets are sold to an associated party.

Sale of shares

Unlike the sale of petroleum assets, the sale of shares in a controlled petroleum mining entity is not taxable income (and the purchase of the shares does not give rise to deductions).

A controlled petroleum mining entity is a company 90% owned by five or fewer persons where the market value of its petroleum mining assets are more than 75% of its equity.

In the event of the sale of shares in a controlled petroleum mining company, the unamortised balance of petroleum expenditure moves with the company to continue being deducted over time.

Investment structures

Oil and gas exploration and production activities are commonly undertaken as joint ventures in order to share risk. In New Zealand, these are typically structured as unincorporated joint ventures. However, the joint venture interest may also be held in a special purpose company in order to limit liability. For income tax purposes, an unincorporated joint venture is disregarded and each joint venturer is attributed their share of the joint venture income and expenditure. The effect is that each joint venturer is able to immediately access the tax deductions arising from the expenditure incurred by the joint venture.

Specific tax rules apply to farm-out arrangements. Farm-out arrangements essentially allow an explorer to share the risk of the venture with another party. For income tax purposes, amounts received by the 'farm-out' party are excluded income. Payments made by the 'farm-in' party are treated as payments under the petroleum mining regime (i.e. as either petroleum exploration or petroleum development expenditure).

Non-resident service providers

A number of service providers to the New Zealand oil and gas industry are based offshore. Tax issues will arise in respect of these service providers, in particular in relation to the non-resident contractor tax that the customer is liable to deduct from payments to any contractor for services provided in New Zealand. We find that these issues can often have a significant effect on the costs and operations of the petroleum permit holder as contractors may seek to impose these costs back on to their customer.

There is a temporary tax exemption, currently available until December 2019, that provides an exemption from New Zealand tax to a non-resident on income earned in New Zealand from operating seismic survey vessels and offshore drilling rigs. Despite the exemption, depending on the circumstances, the non-resident may still have other New Zealand tax obligations such as goods and services tax and employee taxes.