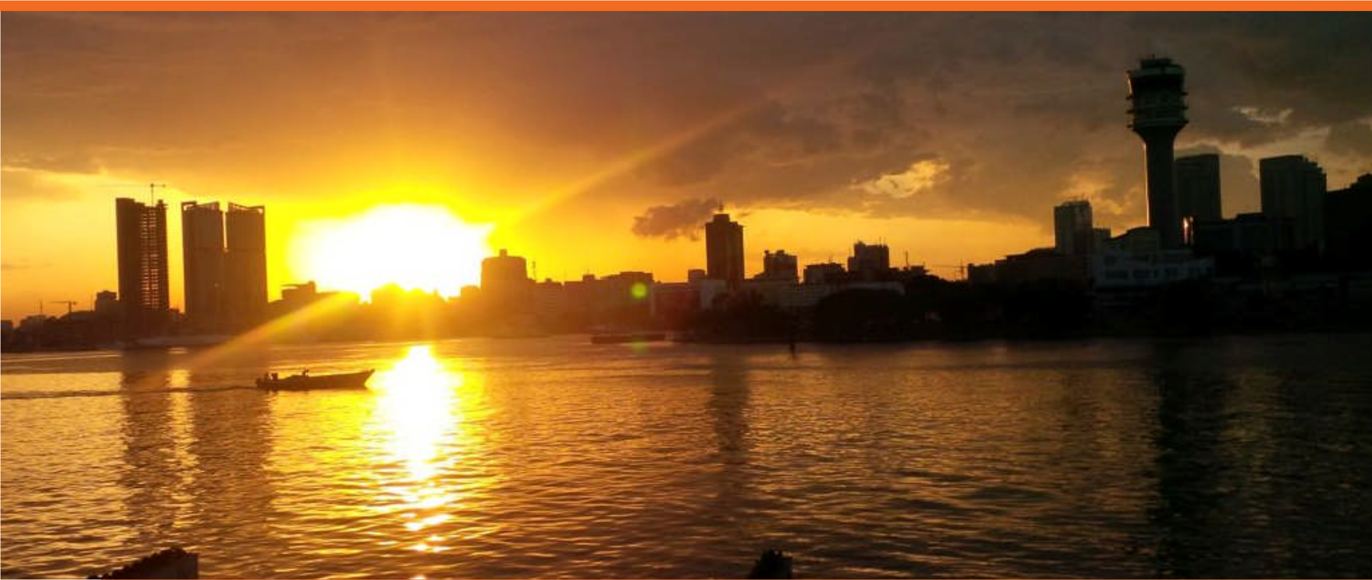

PwC insight and analysis

Summary of points specific to Extractive Industry, additional to those highlighted in our separate Finance Bill 2016 Update

We hope that you will find this update helpful and look forward to your comments

Finance Bill 2016 Extractive Industry Update

PwC Commentary – Extractive Sector (Mining; Oil and Gas)

General

The Finance Bill introduces separate sections dedicated to Mining (Part V, Division IV: Minerals) and Oil Gas (Part V, Division V: Petroleum) and removes the existing tax provisions relevant to these industries. The new provisions are similar for both sectors, and so our newsletter below address both industries jointly, but highlighting differences where these apply.

For the mining sector, the question will arise as to whether stabilisation commitments given under existing Mining Development Agreements ("MDAs") will be respected. For the oil and gas sector, these sudden changes will reinforce their existing concerns that the Production Sharing Agreement ("PSA") model does not include explicit stabilisation of their income tax treatment.

Immediately below is a table summarising the changes. This is followed by a commentary on a number of the changes.

New Provisions in the Act	"Division IV Minerals" and "Division V: Petroleum"
Tax rate	30% for mineral operations / mineral rights, and 35% petroleum operations / petroleum rights
Ring fencing	**Mining** To apply to "each separate mineral operation", and general rule is that each mineral right constitutes a separate mineral operation (subject to special considerations in relation to interaction of prospecting and mining licences, and extension of mining licences) **Petroleum** To apply to "each separate petroleum operation", and general rule is that each petroleum right constitutes a separate petroleum operation (subject to special considerations in relation to interaction of exploration licence and development licence). Ring fencing ends at the delivery point identified in the PSA.
Transfer pricing	To apply to ring fenced activities of the same person
Disposal of mineral and petroleum rights	Treated separately from normal income (from "mineral operations" or "petroleum operations") and classified as "investment asset" not "business asset". Included within scope is "any form of payment or benefit to be derived in the future" from the realization of such an asset, and the value of such amount will be the "present value of a reasonable estimate of the amount of the future payment". Tax to be collected by way of single instalment tax at time of transaction

New Provisions in the Act	"Division IV Minerals" and "Division V: Petroleum"
Joint holding of mineral right	Treated for tax as a partnership
Tax depreciation	• 20% straight line on all assets used in mining or petroleum operations • Removal of grandfathering provision of 100% mining deduction under ITA 1973
Bonus payments	No deduction for bonus payments in respect of grant, transfer or assignment of mineral or petroleum rights
Rehabilitation expenditure	**Mining** Relief for contributions to and other expenses incurred in respect of a rehabilitation fund* as required by law or approved by the Minister under Mining Development Agreements. No relief for expenses incurred in implementing an approved mine closure fund in excess of the amount contributed to the approved rehabilitation fund **Petroleum** Relief for amounts deposited in respect of the decommissioning fund for the petroleum operation. Relief applies to upstream, midstream and downstream. "Decommissioning fund" with respect to petroleum operations means a fund established under the Petroleum Act
Tax Losses	Offset of brought forward losses limited to 70% of current year profits, with any balance carried forward. For mining, the restriction applies not only for mineral operations, but also for processing smelting and refining activities. For petroleum, the loss restriction rules apply not only to upstream but also midstream and downstream activities Express prohibition of the deferral of depreciation allowance claims Alternative minimum tax not applicable

* " rehabilitation fund" with respect to mineral operations or with respect to processing, smelting or refining minerals means a fund-
(a) required by law, a mineral right or under a development agreement and approved for that purpose by the Minister responsible for mining;
(b) which is established to meet expenses to be incurred in the course of rehabilitation of the operations including expenses under an approved mine closure plan; and
(c) where contributions to the fund are placed beyond the control of the person conducting the operations

Commentary

	Change made	Commentary
General		
Tax rate	Tax rate for oil and gas companies increased to 35%.	For existing investors this will adversely change the economics of the current potential projects. It will also influence prospective investors in the sector. Overall, given the current predicament of the global oil market, and against a background of subdued interest in Tanzania's most recent (2013) oil and gas licensing round which predated the oil price collapse, this is a strange decision (unless it contemplates that the model PSA and existing PSAs will be amended to provide more beneficial terms for investors with regard to production share).
Mineral interests		
Disposals of interest in mining/petroleum licence	The disposal of an interest in a mining/petroleum licence is now treated as an investment asset as opposed to a business asset. In addition, the consideration includes "any form of payment or benefit to be derived in the future" from the realization of such an asset, and the value of such amount will be the "present value of a reasonable estimate of the amount of the future payment". Tax is to be collected by way of single instalment tax at time of transaction.	The interest in the mining/petroleum licence will be looked at in isolation. In particular, expenditure incurred on the respective project cannot be utilised to offset the income from the disposal of a licence, and the person acquiring the licence does not obtain a deduction for the expenditure they incur on the licence until it is sold again (if it is sold again). The inability to offset costs incurred on a licence in effect results in double taxation, or to put it another way a higher effective rate of tax on profits. We believe that the better approach is the existing one where no distinction is made between the mining licence and the actual project. However, if such a distinction is to be made, then it would be more reasonable for disposals of such interests to be subject to tax at a much lower rate - for example, Nigeria has a 10% tax rate on disposals of interests in oil and gas interests. The extractive industry is characterised by small companies which specialise in exploration activity ("juniors"), who then sell on the rights for any finds to the more established companies ("majors"). This provision will make Tanzania unattractive economically for juniors, potentially limiting the growth of the industry. The inclusion of commitments to fund future expenditure in "farm out" arrangements will work as a disincentive to exploration. For this reason best practice (adopted in many other jurisdictions) is normally not to tax such commitments. In this regard we would quote an extract from a recent UN paper on the taxation of capital gains which states the following:

	Change made	Commentary
		• *"More typically with respect to extractive industry projects of large scope, introduction of co-venturers simply results in the new investor taking on the responsibility to fund a share of ongoing costs. Generally, these conventional farm-out agreements do not involve cash, or the retention of an overriding royalty. To the extent cash is received, it is generally taxable to the recipient."* • *"A major consideration in allowing additional partners to join in the ongoing exploration and/or development of natural resources in a non-taxable fashion is to maximize the chances for full development and provide an efficient way of achieving risk sharing. Given the size and extent of the risks involved in large natural resource developments, policies that facilitate risk sharing will be viewed very favourably by investors. In contrast, policies that in effect place restrictions or additional costs on commonly employed transactions that facilitate risk sharing can make a prospective investment significantly less attractive."* Aside from the policy issue there is a practical one as to how one would value such future commitments to spend money. The legislation does provide for the application of the *"present value of a reasonable estimate of the amount of the future payment"*, but this begs the question as to how this value is arrived at, and indeed what happens if the future payment is never made.
Treatment as partnership	The joint holding of a mineral right or petroleum right is treated as partnership for tax purposes. The legislation therefore requires a partnership tax return to be filed for each licence interest that is jointly owned. The taxable income calculated in this return would then be allocated to each 'partner' holding an interest, who would then bring this income into tax in their tax return.	This treatment is logical given that a partnership is defined as *"any association of individuals or bodies corporate carrying on business jointly, irrespective of whether the association is recorded in writing"*. However the interaction with other provisions also needs to be considered. For example, a partnership falls within the definition of an entity, and therefore any tax provisions applicable to entities will be in point. One provision of particular relevance to the extractive sector bearing in mind the frequent acquisition, disposal and capital raising activity is the change of control provision (section 56 ITA 2004) which applies to an entity, and therefore could be applied to a partnership.

	Change made	Commentary
		The concern here is that if there is a change in the underlying ownership of one or more partners (joint holders of a licence) such that the underlying interest in the partnership changes by more than 50%, this could result in a deemed realisation of the whole licence even though only one party to that licence has entered into a transaction. This concern already exists in relation to companies which have more than one shareholder and so is not a new issue, but what is new is that the scope of the potential problem becomes wider.
Loss relief and ring-fencing		
Loss relief	Where a company has losses from a previous period, these losses can only be used to shelter a maximum 70% of the taxable profits. In addition to this, the alternative minimum tax is no longer applicable to mining or oil & gas operations. These rules also apply to entities engaged in processing, smelting or refining/midstream and downstream activities.	This amendment will mean that where an extractive company has current year taxable profits (before brought forward losses), tax will be payable on at least 30% of those profits. From an economic perspective, this is similar to the cost recovery basis / production share provisions in the PSAs of oil and gas companies. From a practical perspective this amendment is likely to affect extractive operations from the sixth year of generating income – assuming that there will be no current year taxable profits in the first five years as a consequence of tax depreciation claims on initial development capital expenditure (which is to be written off straight line over five years). Nevertheless, ideally such a provision would explicitly exclude its application in the first ten years (perhaps first five years of operation). For a project that is sufficiently profitable, this will not result in a higher tax take over the life of the project but simply an acceleration of corporate income tax payments, but this will still change the economics of projects. In particular, the obligation to pay tax earlier is likely to increase capital requirements and may therefore increase interest costs. For projects that are not sufficiently profitable, there is a risk that at the end of the project life there are unutilised tax losses which in effect would mean the project would have been taxed on profits never earned.

	Change made	Commentary
Ring-fencing	Ring-fencing is now defined by licence area, with special provisions to allow losses to move from prospecting/exploration licence to mining /development licence for mining and oil & gas companies respectively. Transfer pricing provisions apply to ensure transactions by the same person across a ring-fence (for example, from upstream to midstream oil and gas activities) should be at arm's length.	Ring fencing was already incorporated into the ITA 2004 by way of amendments made in Finance Act 2013, so the concept is not new. However, the concern remains that ring fencing provisions can dis-incentivise exploration activities by companies already in the country who are the ones most likely to carry out additional exploration. Such a measure therefore can constrain the growth of the industry. The application of the transfer pricing legislation will require transfer pricing documentation to be prepared which demonstrates that any transactions across the ring-fence are at arm's length.
Tax deductions		
Capital expenditure	Capital expenditure incurred by Mining and Oil & Gas operations are depreciated at a fixed 20% straight line basis – in other words, a straight line write off over 5 years. The claim for such depreciation cannot be deferred to a later period. The provision grandfathering the ITA 1973 100% tax deduction for mining companies has been removed.	The definition of capital expenditure is very broad, allowing for immediate depreciation deduction of expenditure on reconnaissance, appraisal and prospecting or exploration operations or in developing mineral or petroleum operations and infrastructure with further provision for this to be extended by the regulations. A deduction is also available for additions to the accounting fixed assets where they are owned and employed by a person wholly and exclusively in the mineral or petroleum operations. The deferral of deduction is included to prevent companies trying to minimise the impact of the loss relief limitation by manipulation of current period taxable profits.

	Change made	Commentary
Decommissioning/ rehabilitation	Relief for rehabilitation and decommissioning by Mining and Oil & Gas operations respectively is only available when contributions are paid into a rehabilitation fund or decommissioning fund. The money in the fund is required to be placed outside the control of the person conducting the operations. These rules also apply to entities engaged in processing, smelting or refining/midstream and downstream activities.	The requirement to pay into the funds does require significant cash to be locked in the fund – cash that could otherwise be used by these companies to spend on exploration or development operations. No reference is made to alternative approaches, for example there are financial instruments available which can ensure that there is sufficient provision to cover such costs (for example bank guarantees) without locking in this cash. Given the requirement to contribute cash funding, the likelihood is that such funds will be advanced in the latter stages of a project, resulting in a potential mismatch between when a tax deduction can be claimed and when the operations are making taxable profits against which the deduction may be claimed. Ultimately, this may result in expenditure which may not qualify for a tax deduction.
Bonus payments	Tax relief is specifically provided for annual charges and royalties incurred under MDAs, PSAs, Mining Act 2010 or Petroleum Act 2015. However, no relief is available for bonus payments in respect of grant, transfer or assignment of mineral/petroleum rights.	Bonus payments contemplated would seem to target payments made to Government – for example, the signature bonus (on signing of an agreement) and production bonus (on commencement of production) as provided for under the Petroleum Act 2015. The concept of such bonuses would seem to be limited to the petroleum sector and not mining which has no reference to such payments in the model MDA or Mining Act 2010. However, the wording does not explicitly exclude payments to private parties in relation to assignment of mineral or petroleum interests and so could be interpreted to refer to commercial royalty payments. Accordingly, further amendments are required to clearly define what is to be covered by bonus in this context – for example, it is unclear why mining is included as bonus payments are not provided for in the mining legislation. In terms of policy there is a broader question as to why such an expense should not be deductible. From a commercial perspective it is a necessary cost for such a business which should in principle be deductible. Otherwise, the effect is indirectly to increase the effective tax rate on profits.

	Change made	Commentary
Charitable expenditure	In contrast to other taxpayers no relief is now available by what of the charitable expenditure relief available to other taxpayers*.	It is unclear why the extractive sector should be excluded from the ability to claim this relief.
Community Social Relations	No specific reference to this.	In practice the TRA view Community Social Relations expenditure not as a business cost but some form of charitable contribution. By contrast extractive entities see these costs not as charitable but as a necessary cost of doing business as on a practical level such is required to generate the "licence to operate" from the host community. In addition, the current model MDA expressly includes such expenditure as an obligatory requirement. The provisions however make no reference to tax relief for such CSR expenditure. This is a missed opportunity.

*Section 16 ITA 2004 ("gifts to public and charitable institutions") provides for a deduction not exceeding 2% of a person's business income in respect of (i) amounts contributed during the year of income to a charitable institution referred to in subsection (8) of section 64 or social development project; and (ii) any donation made under section 12 of the Education Fund Act, 2001; and (iii) amounts paid to local government authority which are statutory obligations to support community development projects.

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