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PEPANZ Submission: Future of Tax

Introduction

This document constitutes the Petroleum Exploration and Production Association of New Zealand's (*PEPANZ*) submission on some of the issues set out in the Tax Working Group's (*TWG*) Future of Tax Submissions Background Paper published on 14 March 2018 (Background Paper).

PEPANZ represents private sector companies holding petroleum exploration and mining permits, service companies and individuals working in the industry. Regulatory certainty is very important for the petroleum mining industry given the significant capital investments that have been made and the long-term nature of petroleum mining projects. The stability of fiscal policy settings is particularly important.

We thank you for the opportunity to submit to the TWG. We are happy for the TWG and the Secretariat to contact us to discuss any of the points raised in this submission.

Summary

This submission is in three sections and responds to questions in the Background Paper in relation to:

- capital gains tax;
- environmental taxation; and
- fairness and balance.

Broadly, PEPANZ submits that:

- if a capital gains tax is to be introduced, it should not apply to shares or interests in controlled petroleum mining entities;

- it is not appropriate to use the New Zealand tax system to drive desired environmental or other social outcomes;
- New Zealand should not consider replacing the current royalties regime with a resources rent tax; and
- New Zealand's current framework for taxing petroleum mining fairly recognises the unique characteristics of the industry and does not confer undue tax advantages to its participants.

Submission

Capital gains tax

1. PEPANZ notes that the TWG requests submissions concerning whether "New Zealand [should] introduce a capital gains tax (that excludes the family home)?" and, if so, what features it should have. PEPANZ notes further that TWG also requests submissions on the design issues of a capital gains tax (*CGT*. In particular, the TWG request for submissions on:

   1.1. what assets should be covered by a CGT;

   1.2. how a CGT would integrate with current tax laws; and

   1.3. whether capital losses should be ring-fenced to be offset only against capital gains income or should be able to be offset against any income.

2. PEPANZ does not express any views as to whether New Zealand should introduce a CGT as a matter of general tax policy.

3. However, concerning the specific design issues listed above, PEPANZ submits that if a CGT is to be introduced, it should not disturb the current excluded income treatment (in section CX 42) of consideration derived from disposal of shares or interests in a controlled petroleum mining entity (*CPME*).

4. In support of this submission, PEPANZ notes that:

   4.1. *Petroleum mining assets are already fully taxable*: The income that a petroleum miner derives from the disposal of petroleum mining assets is already subject to income tax (section CT 1). As petroleum miners can also claim a deduction for the acquisition cost of petroleum mining assets (sections DT 3 and DT 4), the net effect of the regime is that income tax is paid on the appreciation of petroleum mining assets. Therefore, in the absence of further amendments, taxing the profits derived from the disposal of shares or interests in a CPME, the value of which are explicitly linked to the value of petroleum assets already within the tax net, could result in double taxation of investors in a CPME.

4.2. *A previous tax on shares in controlled petroleum mining entity has already been proven ineffective and repealed*: Capital gains from the disposal of shares in a CPME were previously subject to tax. However, those rules did not achieve their policy objectives as, contrary to the original policy intent, they enabled petroleum miners to obtain deductions in excess of 100% of their capital invested in petroleum mining development and exploration expenditure.[1] Accordingly, sections CJ 6 and DM 6 of the Income Tax Act 1994 (the predecessors of the current sections CX 42 and DT 13) were amended in 2002 to exclude consideration derived from a disposal of shares in a CPME from gross income and prevent deductions for the cost of those shares.

4.3. *Current Government policy makes it unlikely that a new CGT would be effective at raising revenue or equitable*: Any continuation or furtherance of a similar nature of the current Government's policy stance towards petroleum mining (exemplified by the recent ban on all new offshore exploration permits) would:

a) make it increasingly unlikely that any revenue collected by a CGT that applies to CPME shares would justify its associated compliance or administration costs given that current Government policies will only serve to decrease the value of CMPE shares going forward (assuming that a CGT would not have retrospective application, which PEPANZ submits must be the case);

b) mean that any attempt to address previous issues concerning capital losses generated from the disposal of CPME shares by ring-fencing those losses against gains from future disposals (which PEPANZ does not support) would be inequitable because Government policies are actively discouraging further investment in New Zealand petroleum mining.

Environmental taxation

It is not appropriate to use tax system to drive environmental outcomes

5. PEPANZ agrees that New Zealand and the rest of the world currently face profound environmental challenges such as climate change[2] and acknowledges the role of Government policies in addressing them.

6. However, PEPANZ submits that the New Zealand tax system should not be used as a lever to ensure that "consumers and producers face the costs of emissions and other environmental harm" (as suggested at page 15 of the Background Paper).

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[1] See *Petroleum Mining – Base Maintenance: Regulatory Impact and Compliance Cost Statement*, October 2001, and *Taxation (Relief, Refunds and Miscellaneous Provisions) Bill – Commentary on the Bill*, December 2001.

[2] PEPANZ has acknowledged this on many occasions, see for example: http://www.pepanz.com/news/response-to-greenpeace-open-letter-on-oil-and-gas-exploration/ and http://www.pepanz.com/oil-and-gas-new-zealand/responding-to-climate-change/.

7. In support of this submission, PEPANZ notes that:

   7.1. *Targeting particular activities is contrary to the established principles of a good tax system*: The New Zealand tax system should, to the greatest extent possible, be objective and not discriminate against certain activities. This was acknowledged by the 2010 Victoria University Tax Working Group, which espoused 6 key principles of a good taxation system, including that the tax system should be fair and:

   > "Taxes should be efficient and minimise as far as possible impediments to economic growth. That is, the tax system should avoid unnecessarily distorting the use of resources (e.g. causing biases toward one form of investment versus another) and imposing heavy costs on individuals and firms".[3]

   7.2. *Using the tax system to address externalities is contrary to our broad-base-low rate system*: Parliament should minimise the extent to which it uses the tax system in a manner that effectively picks winners and losers, such as by targeting certain activities with additional taxes to address externalities. This is to prevent New Zealand's departure from its broad-base low-rate philosophy and reduce the risk that our tax system becomes something fundamentally different than the mechanism by which revenue is collected to fund the provision of public goods, services and transfers. This view is supported by the 2001 Tax Review, which concluded (in the context of other punitive taxes such as excise and duties on alcohol, tobacco, gaming and petrol) that such taxes cannot readily be justified on conventional policy grounds.[4]

8. New Zealand's tax system is not the appropriate policy tool to drive positive environmental outcomes. Instead, PEPANZ continues to support the use of designated policy tools such as the Emissions Trading Scheme which is demand focussed and target emissions which actually contribute to climate change.[5] Any policy changes proposed by the TWG should be integrated with and not replace such tools.

Resource rent taxes are not appropriate as an alternative to current royalty regime

9. PEPANZ supports the Government, as the owner of petroleum resources, seeking to maximise the value of New Zealand's petroleum resources for the benefit of all New Zealanders.[6]

10. PEPANZ submits that the most effective way to achieve this is the continuation of New Zealand's current approach to impose royalties on the extraction of Crown-owned

[3] https://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/pdf/tax-report-website.pdf, page 15.

[4] https://treasury.govt.nz/sites/default/files/2007-11/taxreview2001-report.pdf, page 41

[5] http://www.pepanz.com/assets/Uploads/PEPANZ-Oil-and-Gas-Questions-and-Answers-April-2018.pdf.

[6] http://www.pepanz.com/dmsdocument/15, page 15.

minerals and, therefore, that New Zealand should not consider replacing this with a resources rent tax (as suggested at page 41 of the Background Paper).

11. In support of this submission, PEPANZ notes that:

    11.1. *The current royalty regime is appropriate:* Royalties from the petroleum mining industry have delivered substantial sums to the Government's Consolidated Fund over a long period. Over the ten year period to 2015 royalties from petroleum production amounted to NZ$3.2 billion.[7] PEPANZ notes that the 2012 review of the current petroleum royalty regime concluded that it is internationally competitive and meets the objectives for an appropriate royalty regime.[8]

    11.2. *Petroleum resources rent tax was considered in a comprehensive review of New Zealand's petroleum tax regime and rejected:* A comprehensive review commissioned by the New Zealand Government in 2009 concluded that a resources rent tax is not appropriate and should not be considered for New Zealand unless very attractive discoveries are made and/or gas prices rise very substantially (which has not occurred). Notably, after modelling the likely impact of Australia's petroleum resources rent tax on New Zealand's industry, the report found that "other things being equal, [it] does not compete with New Zealand's oil taxation system";[9]

    11.3. *Petroleum resources rent taxes are currently under scrutiny in other jurisdictions:* Notwithstanding that Australia recently decided to continue with its petroleum resources rent tax, the Australian Government has acknowledged, as a response to widespread criticism of its effectiveness,[10] that the regime requires significant structural change in order to function as an effective revenue collection tool.[11] PEPANZ submits that the Australian experience is a compelling case for continuing with New Zealand's royalty regime rather than departing from it.

Fairness and balance

12. The Background Paper states that it may be appropriate to consider whether tax concessions that result in some sectors of the economy paying lower effective rates are still relevant and fair (see page 29).

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[7] https://www.productivity.govt.nz/sites/default/files/sub-low-emissions-65-pepanz-53Kb.pdf.

[8] http://www.mbie.govt.nz/info-services/sectors-industries/natural-resources/oil-and-gas/overview-crown-minerals-act-regime/pdf-document-library/Cabinet%20paper%20-%20Royalties%20on%20minerals.pdf.

[9] *Evaluation of the Petroleum Tax and Licensing Regime of New Zealand, Final Report to the Ministry of Economic Development*, July 2009.

[10] https://www.theguardian.com/australia-news/2017/may/13/petroleum-rent-resource-tax-review-author-may-face-senate-questions.

[11] https://treasury.gov.au/consultation/options-to-address-the-design-issues-identified-in-the-petroleum-resource-rent-tax-review.

13. The petroleum mining industry was not specifically identified in the Background Paper as a sector that receives tax concessions. But given that the petroleum mining tax regime has on many prior occasions been subject to scrutiny, for the avoidance of doubt PEPANZ submits that no material concessions are currently afforded to the petroleum mining industry. This is consistent with the conclusion in APEC's 2015 *Peer Review on Fossil Fuel Subsidy Reforms in New Zealand* that no part of New Zealand's petroleum specific regime constituted "inefficient subsidies that encourages wasteful consumption".[12]

14. In particular, PEPANZ notes that:

 14.1. IRD has recently reviewed the tax treatment of decommissioning expenditure (which led to the replacement of the previous spread-back mechanism with a refundable tax credit) and reaffirmed its view that it is not concessionary. Rather, the treatment recognises that the particular business lifecycle for petroleum mining leads to over-taxation during a petroleum field's productive years and large amounts of expenditure being incurred once revenue generation has ceased that would not otherwise be deductible (i.e. the current regime over-taxes on the way through and that over-taxation is reversed by the credit at the end).[13]

 14.2. The exemption for non-residents rig operators and seismic survey providers in relation to offshore permits (in section CW 57) is not concessionary:

  (a) in 2013, IRD supported extending the period of the section CW 57 exemption, on the basis that if the exemption was repealed no extra revenue is likely to be collected from oil rig operators and firms purchasing their services could pay less tax. This is because the New Zealand tax deductible costs of engaging oil rig operators would increase without any corresponding amount of additional income (Double tax agreements relieving rig operators who are in New Zealand's territorial waters for less than 183 days from any New Zealand taxation);[14]

  (b) in the absence of the exemption, the progress of petroleum exploration and subsequent generation of royalty revenue from any ensuing production would be slowed;[15]

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[12] http://www.mbie.govt.nz/info-services/sectors-industries/energy/international-relationships/pdf-document-library/peer-review-fossil-fuel-subsidy-reforms-nz.pdf, page 13.

[13] http://taxpolicy.ird.govt.nz/publications/2017-ris-areiirm-bill/petroleum-mining-decommissioning.

[14] https://treasury.govt.nz/sites/default/files/2009-02/ris-ird-ete-nov13.pdf.

[15] http://www.mbie.govt.nz/info-services/sectors-industries/energy/international-relationships/pdf-document-library/peer-review-fossil-fuel-subsidy-reforms-nz.pdf, page 40.

(c) by encouraging non-resident rig operators to remain within New Zealand's territorial waters for longer periods, New Zealand generates increased tax revenue by way of PAYE on rig-worker salaries and GST charged on supplies to those employees.

15. The Organisation for Economic Co-operation and Development also identified the immediate deduction of exploration expenditure (in section DT 1) as a concession. However, PEPANZ submits that the treatment is not concessionary and should be retained on the basis that:

    15.1. the general tax rule in New Zealand is that expenditure on research and development is normally deductible in the year it is incurred while expenditure on capital assets should be capitalised and amortised over the economic life of the asset. Allowing immediate deductibility of exploration expenditure is in accordance with this principle because it is not clear at the time exploration expenditure is incurred whether it is of a capital nature, since it is more likely than not that a particular exploration well will not result in a revenue generating asset. Further, if exploration expenditure results in such an asset, the expenditure is clawed back and deducted as petroleum development expenditure; and

    15.2. the measure is consistent with New Zealand's broad-based low-rate tax principles, and is intended to avoid distortions between sectors. Allowing an immediate deduction for expenditure that does not create a capital asset is consistent with New Zealand taxation principles and the treatment of other industries (for example, the deduction for research and development expenditure).[16]

16. PEPANZ notes the *Low-emissions Economy* draft report recently released by the Productivity Commission on 27 April 2018 recommended that "The Government should phase out all subsidies that support the ongoing production and use of fossil fuels."[17] PEPANZ will make a detailed submission on that report separately, but reiterate that for reasons including those set out in this submission none of the tax measures broadly referred to in that report should be viewed as a subsidy to the petroleum mining industry.

17. Please feel free to contact us if you have any questions or would like to discuss any of the points raised in this submission.

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[16] http://www.mbie.govt.nz/info-services/sectors-industries/energy/international-relationships/pdf-document-library/peer-review-fossil-fuel-subsidy-reforms-nz.pdf.

[17] https://www.productivity.govt.nz/sites/default/files/Productivity%20Commission_Low-emissions%20economy_Draft%20report.pdf, page 418.