‘Open for Investment’: A Public Consultation into the Falkland Islands’ Oil Taxation Regime

Contents

1: Introduction and Executive summary

The development and exploitation of the mineral resources of the Falkland Islands will require the attraction of significant sums of private sector investment capital and the taking of material levels of risk of different kinds.

The Falkland Islands Government (FIG) recognises the importance of tailored and locally appropriate regulatory restrictions to protect the natural environment alongside ensuring the fiscal regime is internationally competitive in attracting capital investment. Without delivering a reasonable post tax return to the investor FIG appreciates that oil development will not take place, which would be a loss to the territory's economy - opportunities for local businesses in developing oilfield capability and driving economic growth and new employment prospects for residents.

Oil fields have already been discovered in the Falklands basin and there is further exploration potential and future opportunities for long term hydrocarbon production. It is important to ensure the fiscal regime is designed to support developments throughout their productive lifecycle. Well considered and locally appropriate policy features developed at the start of the provinces' cycle offer the potential for long term stability and building confidence upon which the industry can develop.

Fiscal principles

The Falkland Islands Government (FIG) wishes to use this consultation to set out a number of principles to guide oil taxation policy now and into the future. These are:

- **International fiscal competitiveness** - Ensuring the potential post tax return to the investor is sufficiently high to attract capital investment at each phase of the life of projects in Falkland Islands waters
- **A fair financial return** for the Falkland Islands - In exchange for the exploitation of this non-renewable national resource a fair and reasonable financial return is required to re-invest into national infrastructure and other public spending priorities of the self governing Legislative Assembly
- **Maximising the oil production potential** of the discovered and prospective resource in the region in the early phases and subsequently until the economic limit of the fields brought into development.

This consultation has been designed with a number of objectives:

1) As an opportunity to set out the Government's key policy principles as regards oil taxation in a single document which can act as a reference document for stakeholders with an interest in the region from various perspectives;
2) As an instrument to engage with the investor community to gather views in a structured and open manner. Such views will be used by the FIG to develop policy;
3) To guide the introduction of new legislation and guidance.

We hope you find this engagement positive and productive, and that the responses are as helpful as possible for FIG and Industry to build upon to design the right regime going forward.

Roger Spink MLA
Portfolio Holder, Treasury & Tax

James Wilson
Financial Secretary & Commissioner of Taxation

2: Structure & Design of the consultation

This consultation has been approved by the Executive Council of the Falkland Islands Government on 21st February 2018 for issue on the Falkland Islands Government website and for distribution through stakeholder groups both based in the Falkland Islands itself, and internationally through the Falkland Islands Petroleum Licensees Association (FIPLA) and its member companies.

We thank both the Falkland Islands Chamber of Commerce and FIPLA for their support in communicating this document and the consultation through its membership and the collation of views.

The consultation is intended to be open for a period of six weeks, concluding on Friday 6th April 2018. Whilst representations and responses may be considered after this date, FIG are unable to guarantee that late responses will be incorporated into the policy review period in part or at all. We therefore encourage all interested stakeholders to respond within the deadline.

To facilitate the collation of responses, a dedicated email address has been set up:
oilconsultation@taxation.gov.fk

Written responses may also be sent by post:

Oil Consultation
Falkland Islands Government Taxation Office (FIGTO)
Secretariat
Thatcher Drive
Stanley
Falkland Islands
FIQQ 1ZZ

Questions on this consultation, responses in other formats, and other enquires can be directed to Claire Ralph, Head of Tax using the contact details above or on +500 28476 during office hours (UTC -3).

3(A): An overview of the current oil taxation regime

Taxes Ordinance 1997 and subsidiary legislation

The current domestic tax legislation dates from the Taxes Ordinance 1997 (TO'97) and subsidiary legislation can be found on the Statute Law Database, a new resource for 2017, at www.legislation.gov.fk

Whilst the last consolidation was over 20 years ago significant changes were made to the wider regime in 2003 (primarily around the taxation of Benefits in Kind), more targeted amendments to the oil taxation ringfence were made in 2015, and other ad hoc changes have been required on other occasions.

Domestic tax legislation in a number of areas is based on pre-1987 UK legislation, amended for local factors to make it appropriate for the economic and social circumstances and policies in place in the Falkland Islands. This reflects the Falkland Islands' status as a self-governing British Overseas Territory, and the trading and business relationships between the Falkland Islands and the United Kingdom.

The TO'97 is a relatively concise tax code, and the regime overall is substantially simpler than the modern equivalent in the UK. Tax is charged on the overall profits of companies and incomes of individuals with little distinction between the sources of that profitability or income - for example there are no specific loan relationship or intangible fixed asset/patent box rules, and fewer anti-avoidance rules.

With the specific exceptions relating to oil licenses and ITQ fishing rights, there are no other chargeable gains taxation provisions within the Falklands regime, no equivalent of Value Added Tax, property taxes such as Business Rates and Council Tax, nor Inheritance Tax or other estates taxation.

Currently there is harmonisation of the rates of Income Tax and Corporation Tax, at 21% and 26%, a Payment on Account of Taxation (POAT) regime collecting the majority of income tax at source for employees and a simple residency test based on days physically present within a tax year. A pay and file regime exists for companies, and the Corporation Tax return and accounts are required to be filed 9 months after the end of the accounting period.

A royalty is payable on all hydrocarbon sales in addition to direct and indirect taxation at a rate of 9%. Royalty is deductible for the purposes of computing the Corporation Tax liability.

3(B): FIG's approach to tax

Given the size of the business community, and the resources available to the Taxation Office, an important principle has developed with regard to tax legislation - that of simplicity and proportionality. The Government aspires to have a simple tax regime which is (within reason) easy to understand and comply with from a taxpayer's perspective but one that offers FIG enough protections in the areas of high importance and risk.

As the oil industry moves into its next phase, now is the correct time to undertake a review of particular areas of relevance to the emerging industry of oil development and production in the Falkland Islands.

FIG are looking to introduce new safeguards which are more targeted and quantifiable, to replace general restrictions in the current legislation. These safeguards will be essential to ensure that the exploitation of hydrocarbons yields a fair return in taxation revenues for the FIG Exchequer.

FIG appreciates the importance of certainty for the business community as to how their project will be treated from a tax perspective. This will make projects easier to screen against economic investment criteria and attract competitive financing arrangements to unlock the project from a commercial perspective. Given the number of other sources of risk such as commodity price, reservoir and geological performance, and project delivery it is more efficient to remove other uncertainties. In addition, FIG value certainty from a public finance perspective.

FIG also recognise that there have been developments in intentional tax practice that are relevant to the Falkland Islands that could be incorporated usefully into the Taxes Ordinance to make sure the fiscal regime is as up to date as possible. By drawing on work pioneered by the OECD Base Erosion Profit Shifting[1] (BEPS) project, and strategies used in the UK, FIG hope that reforms will be in familiar areas for international businesses inwardly investing within the Falklands and its offshore area.

3(C): Key areas of focus

Deductibility of finance costs

The first area that the consultation will cover is that of corporation tax deductibility of financing and debt interest. This is a key concern and source of fiscal risk for the Falkland Islands Exchequer because of the risk of large amounts of, or high cost, debt being placed within the scope of FI taxation which shelter profits that would normally be subject to tax within the Falkland Islands.

Leasing and hire-purchase

The next area of focus for the consultation is the two main methods of asset acquisition other than outright purchase.

We are consulting on the introduction of specific 'Hire Purchase' legislation to cover assets acquired under a contract which provides that legal ownership shall or may transfer at some point within the original contract term. The Taxes Ordinance is currently silent on this contractual practice which can offer commercial advantages over outright purchase or traditional leases.

The second aspect is the tax treatment of leased assets. Leasing gives rise to BEPS concerns where the lessor is overseas and the lessee is based in, or operating from, the Falkland Islands and within the charge to FI corporation tax. BEPS concerns can also arise where lease contracts are split from associated services contracts.

Decommissioning relief

The last substantial area of focus for the consultation is the design of the decommissioning tax relief provisions – in particular, the ability to carry back expenses, typically incurred toward the end of a project's productive life when profitability is low. The Taxes Ordinance currently provides for a carry back of these costs for a period of three years - generating limited decommissioning tax relief for the licensee. Extending these time limits will come at significant Exchequer 'cost' as tax receipts over the life of a project will be consequently lower than they would have been otherwise. However FIG is interested in assessing this area of the regime at an early stage and ensuring that a fair proportion of the costs of decommissioning a project are afforded effective tax relief.

[1] http://www.oecd.org/tax/beps/

Other points

A number of additional legislative drafting amendments, in some areas as a consequence of the specific areas upon which we are consulting, and in other areas to improve the clarity of the legislation and its effective application, are also being considered in this process.

The consultation is not specifically covering Royalty which operates alongside the Corporation Tax regime except indirectly through investment economics.

Within the consultation a number of key questions are asked upon which specific responses are sought. General comments are welcomed on the specific design features contained within the main document and the appendices.

4: Financing

Current (relevant) TO'97 provisions: ss. 97, 97A, 104, 152, 152A, 154, 155, 160 and transfer pricing rules – some, but not all, of these rules are specific to ring-fence trades (i.e. the oil industry).

General anti avoidance provisions ensure that only interest expenses related to the activities of the business within the Falkland Islands are deductible for FI taxation. Under section 155, financing costs between certain connected parties and those between entities where a 'special relationship' exists are only allowable to the extent that the Commissioner of Taxation specifically allows.

Feedback gathered from stakeholders to date suggest that insufficient guidance has been provided in the past about the factors on which the Commissioner will make his or her decision to allow finance costs. The consequence of this uncertainty is that investors assume a negligible amount of these costs to achieve effective relief.

FIG is concerned to protect against the trend known colloquially as 'debt dumping'. This is where multinational companies strategically place high cost, or high levels of debt finance in regions where profits are relatively highly taxed in order to minimise their global tax liability. This issue is the focus of the OECD's BEPS Action 4 Report[2].

The OECD advocated an approach of a quantifiable limit on interest deductibility through the establishment of a fixed ratio rule (and optional group ratio rule) - the concept that net interest expense should not be deductible above a certain proportion of the company's (or worldwide group) EBITDA.

FIG considers that this model could usefully be applied to the regime in the Falkland Islands to good effect. The proposal is to introduce a simple fixed ratio of 30%, in a new section 155A TO'97. This rule will only apply for ring fence trades. The benefits of this approach include: certainty for the investor - the amount of tax relief that is regarded as excessive and therefore denied is quantifiable and known with a reasonable degree of accuracy at the investment appraisal stage; simplicity to operate and administer for FIG and for industry without being overly resource intensive; internationally recognisable for overseas investors and comparable to other jurisdictions; and proportionate to the risk posed to the Exchequer.

In conjunction with the fixed ratio rule section 155 TO'97 changes will be made and new guidance will be published on section 155 to make clear that the Commissioner will only be entitled to exercise discretion to disallow deductibility for intra-group and other special relationship debt, and for arrangements motivated by tax avoidance.

Draft legislative provisions, which are indicative only at this stage, are included in Appendix 2(I).

In relation to these draft provisions, FIG would like to pose the following consultation questions:

Q4.1) FIG have selected 30% at the percentage around which a fixed ratio will be structured, this being the upper limit of the OECD's recommended 10-30% corridor. Do you agree with this figure, and for what reasons?

Q4.2) FIG have deliberately set out a wide definition of 'finance charges' for the purpose of the fixed ratio to cover all amounts which are, or could be seen as, equivalent to debt interest. Do you believe any

[2] http://www.oecd.org/ctp/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report-9789264241176-en.htm

of the included categories are inappropriate, or categories that ought to be included which are currently not so. Please give supporting evidence and justifications for your responses.

Q4.3) Similarly FIG have provided an indicative list of items which will comprise tax-EBITDA for the purposes of the fixed ratio. Do you believe that such a definition is correctly targeted and appropriate for the objectives that FIG have set out? Please give supporting evidence and justifications for your responses.

Q4.4) FIG have suggested a 'de-minimis' allowance to ensure that the fixed ratio is targeted in its operation to the taxpayers with the largest net finance charges, which are therefore the most material to the FIG Exchequer. This has been set at £100,000 per annum. Do you support the introduction of a de-minimis allowance and its proposed level? Please give supporting evidence and justifications for your responses.

Q4.5) Amounts of finance charges above the fixed ratio that have been disallowed in that period can be brought back into account in future periods if there is 'spare capacity' within the fixed ratio in future years. FIG have suggested a carry forward period of 3 years. Do you support the concept of a carry forward period and its proposed length? Please give supporting evidence and justifications for your responses.

Q4.6) The proposed fixed ratio is foreseen to overlap with a leasing restriction to the extent that elements of hire purchase or leasing contracts are equivalent to a payment in respect of the underlying asset and a finance charge. Do you support the proposals for how these restrictions should work together to minimise any economically distorting effects? Please give supporting evidence and justifications for your responses.

Q4.7) A certain amount of additional administration is required to monitor and apply the fixed ratio accurately by FIGTO. Whilst the structure of the proposed finance charges restriction return is yet to be developed with industry, at this stage do you have any comments or observations you would like to feed in at this point for future consideration? Do you feel that the proposed return is proportionate and reasonable to comply with? Please give supporting evidence and justifications for your responses.

5: Securing relevant business assets (A: Hire Purchase)

Current relevant TO'97 provisions: none

The Taxes Ordinance does not currently contain specific provisions governing the acquisition of capital assets through arrangements referred to as 'hire purchase', where payments are made under the contract which entitles to the payer to acquire economic ownership in the underlying asset with legal ownership transferring to the payer upon completion of the contract, or an option to buy the underlying asset at the end for an amount which is not equivalent to its market value at the point of purchase.

Historically hire purchase arrangements have not been extensively used by the business community within the Falkland Islands and therefore specific provisions haven't been required to date. FIG expect this to change in the future, and would like to consult on their introduction within this larger project.

Feedback from stakeholders to date has identified this as a source of fiscal uncertainty because they are unclear as to the way in which the Depreciation Allowances regime for acquisitions of assets operates and the amount of capital investment they are able to claim allowances upon.

Other jurisdictions, such as the United Kingdom, have longstanding specific tax legislation governing hire purchase arrangements to align the tax treatment of hire purchase arrangements with a financing and outright ownership of the asset. It is not uncommon for jurisdictions to deem the hirer under a hire purchase contract to be the legal owner of the asset from the outset of the contract with the capital cost being relieved through capital allowances.

FIG are attracted to borrowing from this model, which has worked well for a significant period of time. It is felt that this gives the investor certainty of how such contracts will be treated from a tax perspective. It makes the Depreciation Allowances code available within the oil ring fence on the proportion of the payment representing the capital part. It is simple to model for investment appraisal metrics, and is a reasonably manageable from an administrative perspective. Part of the hire purchase contract's cost will, by elimination, represent financing charges and therefore deductibility will be subject to the fixed ratio discussed in the earlier section.

The proposed rule is designed for transactions in the nature of financings where economic ownership passes. The United Kingdom also nowadays has a "long funding lease" regime, which deals with availability to lessees (rather than lessors) of tax depreciation allowances even without an option to purchase. The regime is complex and it was introduced against the background of an established local tax-based finance leasing market. There is no identified need for equivalent rules in the Falkland Islands.

Draft legislative provisions, which are indicative only at this stage, are included in Appendix 2(II).

In relation to these draft provisions, FIG would like to pose the following consultation questions:

Q5.1) As a matter of policy, do you support the introduction of specific hire purchase rules within the Taxes Ordinance and do you think they will be useful for your business or those in your supply chains?

Q5.2) Hire purchase rules have been devised to apply only to assets within the plant and machinery (including ships and vehicles) category of the current Depreciation Allowances regime. Do you agree with this approach? If not please give supporting evidence and justifications for your responses.

Q5.3) FIG have defined hire purchase as contracts which transfer substantially all the risks of ownership to the other party, and which under the performance of the contract legal ownership shall or may transfer to the other party. Do you agree with this definition? If not please give supporting evidence and justifications for your responses.

Q5.4) The legislation is designed to deal with contracts where legal ownership does in fact transfer to the purchasing entity upon completion of the contract, but also addresses instances where (although ownership may transfer) this doesn’t ultimately take place. Do you feel that these provisions are effective and proportionate? If not please give supporting evidence and justifications for your responses.

6: Securing relevant business assets (B: Leasing)

Current relevant TO'97 provisions: s.97,152A

From an Exchequer perspective, leasing offers risk of BEPS, where profitability could be shifted away to low tax jurisdictions in which the asset is legally owned. This could occur where connected party transactions are mispriced or through the splitting of contracts ('bifurcation') and more of the profits are routed through the lease, leaving a disproportionate amount of expense in the local entity subject to Falkland Islands taxation.

In 2015 a significant change was made to how the Taxes Ordinance treated payments incurred under a lease, affecting businesses carrying out a ring fence trade. As a result of concerns about leasing arrangements being used to avoid tax, leasing costs incurred between connected parties were statutorily disallowed (s.152A(5)) and those between unconnected parties are only allowable to the extent that the Commissioner of Taxation does not disallow them having regard to all the circumstances.

General anti avoidance provisions ensure that only lease costs in respect of assets used in relation to the business activities within the Falkland Islands are deductible for FI taxation.

Feedback gathered from stakeholders to date suggests that these restrictions have the potential to disallow genuine economic costs incurred by an investor either directly or their supply chain partners. This disallowance would force investors to directly acquire all plant and machinery directly, ruling out leasing as an option given the tax cost created by the disallowance.

Leasing is expected to be a very significant issue in relation to the oil industry in the Falkland Islands given – that assets will be brought in for relatively short periods and subsequently leave. Leasing can be an effective way of securing these assets.

Whilst FIG are keen to ensure there is not a specific tax advantage to be gained from leasing assets into the territory rather than purchasing them outright, it is also undesirable from an economic perspective to force investors to purchase assets because the after-tax cost of leasing is higher.

FIG recognises that the restrictions introduced into s.152A are insufficiently targeted to balance the Exchequer and investor positions. However, FIG are also mindful of the difficulty that tax authorities have encountered with relying purely on transfer pricing rules in this area. Drawing on the approach taken in the United Kingdom in 2014, FIG are minded to repeal s.152A and replace it with an amended version of a UK's hire cap. This would limit deductions for leasing costs for corporation tax purposes, by reference to a percentage of the historic cost of the asset being leased.

FIG are aware that the industry did not support the introduction of the UK's bareboat chartering rules in 2013/14, and the UK's version was ultimately targeted on a subset of asset types (drilling rigs and accommodation vessels 'flotels'). However, FIG need to protect the FI Exchequer from moderate BEPS risk and think that this is a (more) proportionate and simple approach – further, that the return to the territory can be made 'fair' by setting the percentage at the correct level. It would also afford industry certainty that the majority of leasing costs will be allowable for corporation tax, on a basis that was quantifiable and capable of modelling throughout the term of the contract.

Given that s.152A was effective from 1 October 2015 onwards, and the lack of transitional provisions to cover payments made under contracts entered into prior to this date, FIG's intended approach is to apply the amendments introduced to leasing (the hire cap) to be retrospectively applied back to 1 October 2015.

Draft legislative provisions, which are indicative only at this stage, are included in Appendix 2 (III).

In relation to these draft provisions, FIG would like to pose the following consultation questions:

Q6.1a) Given the policy objectives in this section and elsewhere in the document, especially to secure a 'fair' return for the Falkland Islanders from oil activity within the territory's waters, do you agree that a hire cap is a reasonable approach to replace s152A and ensure a targeted approach to the BEPS risk the FI Exchequer faces?

Q6.1b) If you do not support the concept of a hire cap please suggest an alternative methodology (other than the simple application of transfer pricing rules) that the FIGTO could employ to mitigate against the BEPS risk the FI Exchequer faces and ensure taxpayers obtain a 'fair' level of tax relief for the cost of leased assets operating within FI waters.

Q6.2) The new hire cap at s.152A is intended to apply to lease contracts related to the oil ring fence. Given this policy objective do you feel that the mechanics at s.152B(1)-(4) are accurately and appropriately drafted? If not please give supporting evidence and justifications for your responses.

Q6.3) s.152B defines 'lease' for the first time within the TO'97. Do you feel that the definition gives sufficient clarity and certainty required from your business interests in the region? If not please give specific areas of remaining uncertainty and any necessary supporting justifications for your responses.

Q6.4) s.152C sets out the application of the hire cap to moveable assets including vehicles and ships of all types, although with the powers to set different levels of cap for particular asset types. Do you agree with this policy objective and the drafting of s.152C and 152D in this respect? If not please give supporting evidence and justifications for your responses.

Q6.5) A minimum market value has been suggested at £2 million to ensure the hire cap restriction is only applied to the larger assets which represents the most significant BEPS risk to the FI Exchequer. Do you think that the drafting of a de-minimis value is sensible and do you feel that £2 million is an appropriate level for this to be set? If not please give supporting evidence and justifications for your responses.

Q6.6) A certain amount of additional administration is required to monitor and apply the hire cap restriction accurately by FIGTO. Whilst the structure of the proposed leasing return is yet to be developed with Industry, at this stage do you have any comments or observations you would like to feed in at this point for future consideration? Do you feel that the proposed return is proportionate and reasonable to comply with? Please give supporting evidence and justifications for your responses.

7: Decommissioning

Current relevant TO'97 provisions: s.114

Under provisions in s.114(10) losses incurred on decommissioning can be used against any current-year profits and any excess carried back to against taxable profits for the previous 3 years. Alternatively, relief can be taken as capital allowances for use against taxable profits in future periods.

All costs related to the decommissioning of an oilfield (plugging the wells, removal of seabed structures, transporting any equipment onshore for recycling, etc) should achieve tax relief under the provisions of s.114 as currently drafted.

Feedback gathered from stakeholders to date suggests that, as profitability falls throughout a project's life and decommissioning approaches, stand-alone projects create insufficient taxable profits to absorb the decommissioning expenditure and grant full relief. The consequence is that expenditure could be 'stranded' without effective relief for tax purposes. The consequence for investment is that Investors assume a negligible amount of these costs will achieve effective relief, potentially curtailing the productive life of a field prematurely. FIG are therefore willing to consider an extension to the 3 year period in which decommissioning costs can be carried back to trigger repayments of tax already paid by the company.

The principles of the carry back mechanism, with costs being set off against profits for later years first (known as 'last in first out') are not being considered for amendment, nor the principle of relief being limited to the profits upon which tax has already been suffered, nor changes to the type of costs upon which decommissioning relief is available.

In order to consider amendments to the carry back period for decommissioning costs FIG would like to better understand the impact of this restriction of the economic performance of projects within the Falkland Islands with the current 3 year limit compared to a longer time period.

Q7.1) With the benefit of supporting evidence and modelling provided, does the current statutory provision of a 3 year carry back lead to expenditure being 'stranded' (i.e. not capable of achieving economic relief) in your investment cases? Is such a level of stranded expenditure material to your investment case, and to what extent?

Q7.2) Are there other provisions within the current statutory provisions related to decommissioning which cause effective relief to not be available for decommissioning expenditure incurred at any stage of the investment cycle? Please give supporting evidence and justifications for your responses.

8: Other issues and technical changes relating to the oil industry

Current relevant TO'97 provisions: Various.

This consultation has been focused on key areas of the tax regime to the extent they apply to, and are likely to be material considerations for, oil investment projects within the Falkland Islands. Alongside the areas focused upon in other sections of the document FIG are interested in hearing feedback from stakeholders about areas, other than those already raised with FIG directly, which may be of relevance to investors.

Q8.1) Are there any other areas of the current Taxes Ordinance, other than issues that have been raised to FIG directly and are therefore already known and understood, that result in material uncertainty to the taxpayer? Please give full supporting evidence and justifications for your responses.

With the current Taxes Ordinance having developed over time, FIG are interested in hearing from stakeholders about areas of the code which could be clarified for the benefit of the Investor, and for FIG administering the tax regime overall. One known example is section 124A 'Restriction of depreciation by reference to asset value in accounts' where the policy intention is to ensure that Depreciation Allowances for the purposes of Corporation Tax is not exceeded by the reduction in the asset value in the financial statements for the period in which owned assets are within the Falkland Islands. This is to avoid a burdensome process of valuations being required when an asset first comes into the Falkland Islands, and a second valuation upon departure to calculate the degree of economic impairment during its use in the trade.

Q8.2) Are there other areas of the Taxes Ordinance, including s.124A discussed above, where technical improvements to the code could be usefully made to achieve the same policy objectives but in a more effective or efficient manner ? Please give full supporting evidence and justifications for your responses.

9: Conclusions and next steps

In launching a public consultation of this nature FIG hope that a thoughtful and considered engagement with Investors and other stakeholders can take place in a way that delivers meaningful and useful policy debate on issues of material importance to the FIG Exchequer, the economy of the Falkland Islands and the development of the oil industry in the region.

Transparency and openness are key features of a modern democracy and public administration and in that vein it is useful at this point to set out the next steps for when the consultation closes.

All responses received on time will be thoroughly considered by FIG Officers from a number of disciplines and summarised for Members of the Legislative Assembly. Based on policy decisions made by the Assembly and Executive Council, It is planned that Legislative amendments and guidance as necessary will be developed for enactment and implementation during 2018.

Appendix 1: List of Consultation Questions

Q4.1) FIG have selected 30% at the percentage around which a fixed ratio will be structured, this being the upper limit of the OECD's recommended 10-30% corridor. Do you agree with this figure, and for what reasons?

Q4.2) FIG have deliberately set out a wide definition of 'finance charges' for the purpose of the fixed ratio to cover all amounts which are, or could be seen as, equivalent to debt interest. Do you believe any of the included categories are inappropriate, or categories that ought to be included which are currently not so. Please give supporting evidence and justifications for your responses.

Q4.3) Similarly FIG have provided an indicative list of items which will comprise tax-EBITDA for the purposes of the fixed ratio. Do you believe that such a definition is correctly targeted and appropriate for the objectives that FIG have set out? Please give supporting evidence and justifications for your responses.

Q4.4) FIG have suggested a 'de-minimis' allowance to ensure that the fixed ratio is targeted in its operation to the taxpayers with the largest net finance charges, which are therefore the most material to the FIG Exchequer. This has been set at £100,000 per annum. Do you support the introduction of a de-minimis allowance and its proposed level? Please give supporting evidence and justifications for your responses.

Q4.5) Amounts of finance charges above the fixed ratio that have been disallowed in that period can be brought back into account in future periods if there is 'spare capacity' within the fixed ratio in future years. FIG have suggested a carry forward period of 3 years. Do you support the concept of a carry forward period and its proposed length? Please give supporting evidence and justifications for your responses.

Q4.6) The proposed fixed ratio is foreseen to overlap with a leasing restriction to the extent that elements of hire purchase or leasing contracts are equivalent to a payment in respect of the underlying asset and a finance charge. Do you support the proposals for how these restrictions should work together to minimise any economically distorting effects? Please give supporting evidence and justifications for your responses.

Q4.7) A certain amount of additional administration is required to monitor and apply the fixed ratio accurately by FIGTO. Whilst the structure of the proposed finance charges restriction return is yet to be developed with industry, at this stage do you have any comments or observations you would like to feed in at this point for future consideration? Do you feel that the proposed return is proportionate and reasonable to comply with? Please give supporting evidence and justifications for your responses.

Q5.1) As a matter of policy, do you support the introduction of specific hire purchase rules within the Taxes Ordinance and do you think they will be useful for your business or those in your supply chains?

Q5.2) Hire purchase rules have been devised to apply only to assets within the plant and machinery (including ships and vehicles) category of the current Depreciation Allowances regime. Do you agree with this approach? If not please give supporting evidence and justifications for your responses.

Q5.3) FIG have defined hire purchase as contracts which transfer substantially all the risks of ownership to the other party, and which under the performance of the contract legal ownership shall or may transfer to the other party. Do you agree with this definition? If not please give supporting evidence and justifications for your responses.

Q5.4) The legislation is designed to deal with contracts where legal ownership does in fact transfer to the purchasing entity upon completion of the contract, but also addresses instances where (although ownership may transfer) this doesn't ultimately take place. Do you feel that these provisions are effective and proportionate? If not please give supporting evidence and justifications for your responses.

Q6.1a) Given the policy objectives in this section and elsewhere in the document, especially to secure a 'fair' return for the Falkland Islanders from oil activity within the territory's waters, do you agree that a hire cap is a reasonable approach to replace s152A and ensure a targeted approach to the BEPS risk the FI Exchequer faces?

Q6.1b) If you do not support the concept of a hire cap please suggest an alternative methodology (other than the simple application of transfer pricing rules) that the FIGTO could employ to mitigate against the BEPS risk the FI Exchequer faces and ensure taxpayers obtain a 'fair' level of tax relief for the cost of leased assets operating within FI waters.

Q6.2) The new hire cap at s.152A is intended to apply to lease contracts related to the oil ring fence. Given this policy objective do you feel that the mechanics at s.152B(1)-(4) are accurately and appropriately drafted? If not please give supporting evidence and justifications for your responses.

Q6.3) s.152B defines 'lease' for the first time within the TO'97. Do you feel that the definition gives sufficient clarity and certainty required from your business interests in the region? If not please give specific areas of remaining uncertainty and any necessary supporting justifications for your responses.

Q6.4) s.152C sets out the application of the hire cap to moveable assets including vehicles and ships of all types, although with the powers to set different levels of cap for particular asset types. Do you agree with this policy objective and the drafting of s.152C and 152D in this respect? If not please give supporting evidence and justifications for your responses.

Q6.5) A minimum market value has been suggested at £2 million to ensure the hire cap restriction is only applied to the larger assets which represents the most significant BEPS risk to the FI Exchequer. Do you think that the drafting of a de-minimis value is sensible and do you feel that £2 million is an appropriate level for this to be set? If not please give supporting evidence and justifications for your responses.

Q6.6) A certain amount of additional administration is required to monitor and apply the hire cap restriction accurately by FIGTO. Whilst the structure of the proposed leasing return is yet to be developed with Industry, at this stage do you have any comments or observations you would like to feed in at this point for future consideration? Do you feel that the proposed return is proportionate and reasonable to comply with? Please give supporting evidence and justifications for your responses.

Q7.1) With the benefit of supporting evidence and modelling provided, does the current statutory provision of a 3 year carry back lead to expenditure being 'stranded' (i.e. not capable of achieving economic relief) in your investment cases? Is such a level of stranded expenditure material to your investment case, and to what extent?

Q7.2) Are there other provisions within the current statutory provisions related to decommissioning which cause effective relief to not be available for decommissioning expenditure incurred at any stage of the investment cycle? Please give supporting evidence and justifications for your responses.

Q8.1) Are there any other areas of the current Taxes Ordinance, other than issues that have been raised to FIG directly and are therefore already known and understood, that result in material uncertainty to the taxpayer? Please give full supporting evidence and justifications for your responses.

Q8.2) Are there other areas of the Taxes Ordinance, including s.124A discussed above, where technical improvements to the code could be usefully made to achieve the same policy objectives but in a more effective or efficient manner ? Please give full supporting evidence and justifications for your responses.

<u>Appendix 2: Draft legislation</u>

APPENDIX (I): DRAFT INTEREST RESTRICTION LEGISLATION

1. Sections 152(6)(b) is repealed.

2. Section 155 is amended as follows:

"155 Finance costs: deductibility

(1) Any payment of interest by a company to which this section applies in respect of securities issued by the company-

(a) where the securities are held by a company which owns (directly or indirectly) not less than 75 per cent of the ordinary share capital of the issuing company; or

(b) another company owns (directly or indirectly) not less than 75 per cent of the ordinary share capital of both companies,

shall not be deductible in ascertaining the chargeable income of the company unless and to the extent that the Commissioner directs the company that the payment may be deducted.

(2) Subsection (2A) applies where-

(a) finance charges are incurred by a company to which this section applies ("C") in respect of a financial transaction, and

(b) C has a special relationship with one or more of the parties to the transaction ("SR") or it appears to the Commissioner that the financial transaction has a main purpose of securing a tax advantage.

(2A) The finance charges shall not be deductible in ascertaining C's chargeable income, unless and to the extent that the Commissioner directs that the charges may be deducted.

(2B) For the purpose of subsection (2A)-

(a) "financial transaction" means any transaction under which a finance charge is to or may be incurred;

(b) "special relationship" means any relationship as a result of which C and SR are not dealing, or may not be dealing, at arms' length;

(c) "finance charge" has the meaning given in section 155A(1);

(d) a direction may be specific or general, and conditional or absolute;

(e) the Commissioner shall publish guidance[3] on the criteria to be considered in determining whether or not to give a direction;

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[3] **Note:** Notice 108 in Gazette 13 dated 30 September 2015 provides as follows:

"In accordance with section 152A and section 155 of the Taxes Ordinance (as amended by the Taxes (Oil and Gas) Ordinance 2015) and following consultation with persons appearing to be representative of the petroleum industry, the required guidance is published in this Gazette."

(f) before publishing guidance[i] the Commissioner shall consult persons appearing to be representative of the petroleum industry.

(2C) In the case of a contractor within the meaning of section 150(11), finance charges are deductible in accordance with this section only in so far as attributable (through just and reasonable apportionment if necessary) to assets used in the Falkland Islands.

(3) To the extent a payment falls within subsection (1) or (2) above and also within section 104 or section 152(3) or section 152B, subsection (1) or (2) above (as the case may be) shall apply to the exclusion of section 104 or section 152(3), or section 152B.

(4) Where C enters into a financial transaction in respect of which subsection (2A) applies or may apply, where the finance charges may exceed £50,000 in an accounting period, C shall notify the Commissioner of that fact not later than 4 weeks after entering into the transaction.

(5) ...

(6) This section applies to a company with a ring fence trade.

(7) In this section "securities" includes securities not creating or evidencing a charge on assets, and interest paid by a company on money advanced without the issue of a security for the advance, or other consideration given by a company for the use of money so advanced, shall be treated as if paid or given in respect of a security issued for the advance by the company.

(8) ...”

3. After section 155, insert the following: -

“**155A Finance charges restriction - interpretation**

(1) In this section and sections 155B – 155D, the following shall apply: –

“de minimis allowance” has the meaning given in 155C.

“finance charges” means interest expenses on all forms of debt, other costs economically equivalent to interest and expenses or losses incurred in connection with the raising of finance, including:

(i) payments under profit participating loans;
(ii) imputed interest on instruments such as convertible bonds and zero coupon bonds:
(iii) alternative finance returns payable under alternative financing arrangements, such as Islamic finance;
(iv) the finance cost element of finance lease payments or other arrangements accounted for as a financial liability;
(v) the amortisation of capitalised interest;
(vi) amounts measured by reference to a funding return under transfer pricing rules where applicable;
(vii) notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings;

Subscribers are advised to consult Notice 108 in Gazette 13 dated 30 September 2015 for the full text of the abovementioned guidance.

(viii) guarantee fees for financing arrangements, arrangement fees and similar costs related to the borrowing of funds;
(ix) fees for letters of credit or other financial guarantees in respect of decommissioning liabilities;
(x) gains and losses from derivatives which hedge risks associated with the company's finance,

but excluding: -
(i) foreign exchange gains and losses;
(ii) impairment losses and their reversal;
(iii) gains and losses from derivatives which hedge risks arising in the ordinary course of a trade where the contract was entered into wholly for reasons unrelated to the capital structure of the company or its group;

"finance charges restriction" means the rules on restriction and reactivation of finance charges provided by sections 155A to 155D;

"finance charges restriction return" has the meaning given in section 155D(1);

"net finance charges" means, in respect of a company for an accounting period, the higher of (i) the company's finance charges that would be deductible (before application of the finance charges restriction) less its taxable income from finance charges; and (ii) zero;

"net finance charges allowance" has the meaning given in section 155B(2);

"tax-EBITDA" means, in respect of a company for an accounting period, the chargeable income (if any) of the company for an accounting period, after excluding:
(i) capital gains and allowable losses under Chapter II of Part VI;
(ii) any deductions for finance charges and any taxable income from finance charges;
(iii) any depreciation allowances or charges under Chapter II of Part V;
(v) loss relief under Chapter III of Part V; and
(vi) group relief under Chapter IV of Part V.

(2) The Commissioner may provide in published guidance or make other direction on the operation of the finance charges restriction, including on whether amounts of a particular kind shall be included or excluded from the meaning of 'finance charges' or 'tax-EBITDA', in order to ensure that the finance charges restriction operates on a just and reasonable basis.

155B Finance charges restriction

(1) This section applies to any company carrying on a ring-fence trade. It makes provision for (a) disallowing certain amounts that a company would (apart from this section) be entitled to bring into account for the purposes of corporation tax in respect of finance charges, and (b) allowing certain amounts disallowed under this section in previous accounting periods to be brought into account in later accounting periods.

(2) The 'net finance charges allowance', in respect of a company for an accounting period, shall be the higher of:
(a) 30% of the company's tax-EBITDA; and
(b) the company's de minimis allowance.

(3) A company is subject to a disallowance under this section if, in an accounting period, its net finance charges (before application of the finance charges restriction), exceed its net finance charges allowance.

(4) The disallowance applies to the company's finance charges that would be deductible (before application of the finance charges restriction) in an amount equal to the excess referred to in sub-section (3).

(5) An amount previously disallowed under sub-sections (3) and (4) may be reactivated and brought into account by the company as a deduction in a subsequent accounting period ending within three years of the end of the accounting period mentioned in sub-section (3), if and to the extent that:

(a) in that subsequent accounting period the company's net finance charges are less than 30% of the company's tax-EBITDA; and

(b) the amount previously disallowed has not previously been reactivated.

155C Finance charges restriction – de minimis allowance

(1) A 'de minimis allowance' may be allocated to a company, up to a maximum of £100,000.

(2) The de minimis allowance allocated to a company shall not be available for allocation to any other company which is at any point in an accounting period connected to the first company, to the extent it has been allocated to the first company.

(3) For an accounting periods which are shorter than a year, the maximum de minimis allowance that can be allocated is reduced pro-rata.

(4) Companies which are connected must agree how the maximum of the £100,000 de minimis allowance is to be allocated between them and indicate such allocation in their finance charge restriction returns.

(5) For connected companies with accounting periods beginning or ending on different dates, such adjustments as are just and reasonable shall be made by the company for the purposes of allocating amounts of de minimis allowance.

(5) If it appears to the Commissioner that:

(a) an allowance in excess of the de minimis allowance has been allocated; or

(b) the allocation for a company or connected companies is not clear on a finance charges restriction return, or connected companies appear to not be in agreement; or

(c) for connected companies with accounting periods beginning or ending on different dates, adjustments are not just and reasonable,

the Commissioner may by notice direct in their absolute discretion what the de minimis allowance for those companies shall be, which may be nil.

155D Finance charges restriction – administration

(1) A company within the charge to corporation tax shall submit a 'finance charges restriction return' for each corporation tax year containing such information and in such form as may be prescribed by the Commissioner, including but not limited to:

(a) whether and to what extent an amount of de minimis allowance is to be allocated to the company for an accounting period;

(b) the details of any other companies within the charge to corporation tax and with which the company is connected, and to what extent those companies have been allocated an amount of de minimis allowance;

(b) for the accounting periods relevant to that corporation tax year, a calculation of the company's:
  (i) tax-EBITDA;
  (ii) finance charges that would be deductible (before application of the finance charges restriction);
  (iii) taxable income from finance charges;
  (iv) net finance charges;
  (v) net finance charges allowance; and
  (vi) any disallowance and any reactivation of finance charges under section 155B for the accounting periods; and
  (vii) amounts disallowed under section 155B for previous accounting periods and not yet reactivated.

(3) A company shall promptly procure and provide such other information and copies of such documents as the Commissioner may by notice request for the purposes of assessing the compliance of the company and connected companies with the finance charges restriction including, but not limited to, details of the company's:
(a) financing and hedging arrangements;
(b) counterparties to their financing and hedging arrangements; and
(c) commercial and tax purposes for entering into financing or hedging arrangements.

(4) If a company has not provided a finance charges restriction return as prescribed by the Commissioner, or if the return is deficient or has failed to comply with the finance charges restriction in any way, or the company has not provided information to the Commissioner in accordance with sub-section (2), then the Commissioner may make such amendments to the company's finance charges restriction return as they see fit, and the Commissioner shall notify the company of such amendments.

(5) The submission of a finance charges restriction return shall be required at the same time as, and form part of, a company's corporation tax return and accounts under section 30. The same consequences shall follow for a failure to submit a finance charges restriction return under section 33 as would follow from a failure to submit the company's accounts.

155E Finance charges restriction – anti-avoidance

(1) If the Commissioner determines that in relation to a company or companies there are arrangements which it is reasonable to assume have as their main purpose, or as one of their main purposes, the obtaining of a tax advantage in relation to this section ("avoidance arrangements"), the Commissioner may make such adjustments as are just and reasonable to counteract those avoidance arrangements.

(2) In sub-section (1), a tax advantage in relation to this section includes additional finance charges being brought into account, a reduction in amounts disallowed under section 155B, additional amounts being reactivated under section 155B, a company or a connected company obtaining a greater de minimis allowance, and can include amounts being taken into account earlier or later than would otherwise be the case.

<u>Explanatory notes to legislation</u>

<u>Paragraph 1</u>. These changes are intended to make the existing legislation work alongside the new interest restriction introduced by paragraph 3. Notwithstanding the repeal of sections 152(6)(b) and 155(2C)(b), any interest and finance charges received by oil companies or contractors are still included in their taxable income.

Paragraph 2. Section 155 is aimed at preventing taxpayers from claiming excessive deductions for financing charges. This change is intended to ensure that oil industry contractors, and any other taxpayers who are subject to the ring-fencing rules, are subject to section 155.

Paragraph 3. This paragraph inserts new sections 155A to 155E which, subject to a de minimis, restrict a company's deductions for net finance changes to 30% of its taxable EBITDA. This is intended to prevent deductions where companies have excessive leverage.

- Section 155A defines certain terms used in the finance charges restriction.

- Section 155B compares a company's net finance charges with its net finance charges allowance, and denies deductions for any excess finance charges. It allows companies to bring into account previously disallowed amounts as a deduction if, within 3 years, they have excess taxable EBITDA relative to their net finance charges. This is to allow some flexibility, recognising that net finance charges and EBITDA can be volatile.

- Section 155C provides for a de minimis allowance, so that companies with lower amounts of net finance charges are not subject to the finance charges restriction.

- Section 155D requires taxpayers to submit a finance charges restriction return and provide certain other information and documents to the Commissioner.

- Section 155E is a targeted anti-avoidance rule which counteracts arrangements with a main purpose of obtaining a tax advantage in relation to the finance charges restriction.

Matters for guidance

- Priority of other restrictions on deductibility. The finance charges restriction in section 155B applies after any other rules governing the deductibility of finance charges. For instance, if deductions for finance charges are denied or limited under sections [104, 152, 152A, 154, or 155, or transfer pricing rules] only the deductible amounts would be tested against the fixed ratio.

- Whether leasing costs are part of a company's net finance charges. 'Finance charges' includes all manner of deductions for amounts which are economically similar to interest. For finance leases, it will generally be accepted that a company whose accounts comply with section 30(2) of the Taxes Ordinance should follow its accounting in determining which parts of the lease accounting debits are finance charges and which parts are depreciation. Under current accounting standards, operating leases will generally be accepted as not involving finance charges, although this position will be kept under review and may change in line with new accounting standards.

- Priority of hire cap restrictions on leasing costs. As with other finance charges, leasing costs are only part of a company's net financing charges and tested against the fixed ratio if they would otherwise be deductible after applying other tax rules. In particular, where a deduction for leasing costs has been restricted under the hire cap in section 152A of the Taxes Ordinance, then only the deductible part will be part of the company's net finance charges for the finance charges restriction.

- It may be the case that a taxpayer may have some amounts of their leasing costs disallowed under the hire cap in section 152A, where the leasing costs include a finance charges element. Where this is the case, that taxpayer will need to work out how much of that disallowance was in respect of financing charges. The Commissioner will generally accept that a disallowance under the hire cap applies pro-rata to the depreciation and finance elements of the finance lease debits. By way of example:

    - Suppose that the taxpayer's accounts provide that, under a finance lease, the taxpayer has accounting debits of 40 in the current year, of which 30 is depreciation and 10 is attributable to finance. If that taxpayer's deductions for leasing costs is limited by the hire cap in section 152A to 20, then the disallowance of 20 should be allocated on a pro rata basis. This means that, after application of the hire cap, the taxpayer will be treated as having 5 of debits attributable to finance.

  - If the taxpayer has no taxable income from finance charges, and no other deductions for finance charges, then the taxpayer's net finance charges for the purposes of the finance charges restriction will be 5. It falls to be tested under the finance charges restriction whether the taxpayer's net finance charges exceed its net finance charges allowance.

- <u>Whether letter of credit charges are part of a company's net finance charges</u>. Companies with a ring fence trade may be required to provide letters of credit in the course of their business, and in appropriate circumstances these charges can be treated as deductible expenditure. These may commonly be used in connection with decommissioning security agreements. Letter of credit charges will be counted towards a company's net finance charges.

- <u>Administration</u>. A company carrying on a ring fence trade shall submit, with its tax return, a finance charges restriction return in accordance with section 155D. The company shall supply sufficiently detailed information about the nature of its net finance charges, and such other information as the Commissioner may request, so that the Commissioner may form a view on the correctness of the company's calculations. This may include copies of the loan or lease agreements and any side agreements or amendments.

- The Commissioner has discretion under section 155A(2) to provide in published guidance or make other direction on the operation of the finance charges restriction in order to ensure that it operates fairly. Companies are invited to write to the Commissioner on an informal basis if they feel unsure about the application of any aspect of the finance charges restriction rules in sections 155A-155E to their particular situations, or if the finance charges restriction appears to be operating unfairly in particular situations. Queries should be submitted to [*email address*]

APPENDIX (II): CAPITAL ALLOWANCE AMENDMENTS (HIRE PURCHASE)

In section 106(3)(a) add the words: "(including under section 106B)" after "to him".

In section 106(4) replace the definition of "expenditure" with the following:

""**expenditure**", in relation to the acquisition of machinery or plant or any other asset for the purposes of [section 112, 116 or 117], refers to the amount spent as capital expenditure on the provision of that asset by the person claiming the depreciation allowance as a result of which he is the owner of that asset, subject to sections 121 and 122, but any amount spent on the provision of–

(a) a building (as defined immediately above);

(b) a car park or hard standing; or

(c) any renewable energy technology including its system components,

does not include the cost or value of the land on which it is built, and "acquisition" for the purposes of this definition refers to becoming the owner;".

After section 106A insert the following:

"106B [Machinery and plant] on hire-purchase etc.

(1) Subject to subsection (6), subsection (2) below applies where a person (A) carrying on a business incurs capital expenditure on the provision of machinery or plant [(including vehicles and ships)] for the purposes thereof under a contract which–

(a) transfers substantially all the risks and rewards incidental to ownership to A; and

(b) provides that A shall or may become the owner of the machinery or plant on the performance of the contract.

(2) Where this subsection applies–

(a) the machinery or plant shall be treated for the purposes of this Chapter as belonging to A (and not to any other person) at any time when A is entitled to the benefit of the contract so far as it relates to that machinery or plant, and

(b) all capital expenditure in respect of that machinery or plant to be incurred by A under the contract after the time when the machinery or plant is brought into use for the purposes of the business shall be treated for the purposes of this Chapter as having been incurred by A at that time.

(3) Where A ceases to be entitled to the benefit of the contract in question so far as it relates to that machinery or plant without in fact becoming the owner of the machinery or plant the machinery or plant shall be treated for the purposes of this Chapter as ceasing to belong to A at the time when he ceases to be so entitled, and (subject to subsection (4))–

(a) if A ceases to be so entitled after the machinery or plant has been brought into use for the purposes of the business, the disposal value of the machinery or plant shall be taken as an amount equal to any capital sums [or other money's worth] which A receives, or is entitled to receive, by way of consideration, compensation, damages or insurance moneys in respect of his rights under the contract, or in respect of the machinery or plant (together "relevant capital sums"), together with so much of that capital expenditure as A has not in fact incurred;

(b) if A ceases to be so entitled before the machinery or plant has been brought into use for the purposes of the trade, the disposal value of the machinery or plant shall be the total of any relevant capital sums.

[(4) If the relevant capital sums are lower than the total amount that would be received in the open market or otherwise at arm's length the amount that would have been so received shall be taken in place thereof, and may be determined (where appropriate and without double counting for expenditure not in fact incurred) by reference to what would have been received had A become the owner and sold the machinery or plant in the open market.]

[(5) References to a contract in subsections (1), (2) and (3) include one or more contracts taken together which form a part of a single arrangement between the same persons.]"

[(6) Subsection (2) does not apply to a contract between connected persons.]

In section 113:

add the following at the end of subsection (1):

"(and section 106B(1) [and (2)], which where applicable shall take priority over the events referred to in the following provisions of this section)".

in subsection (2) insert the following after "incurred": "(or treated as incurred, including under section 106B)".

APPENDIX (III): LEASING COSTS AMENDMENTS

1. Sections 152A is repealed and replaced as follows:

152A Circumstances where restriction on hire of relevant assets is to be applied

(1) Section 152B applies if a company that carries on a ring fence trade makes, or is to make, one or more payments under a lease of a relevant asset or part of a relevant asset for the purposes of its ring fence trade, and–

(a) the lessor is an associated person of a contractor;

(b) the lessor is a person who is connected with the company, or was connected with the company when the lease was imposed; or

(c) the Commissioner notifies the company that the Commissioner considers that the lease is made in connection with arrangements with a main purpose of securing a tax advantage.

(2) A person is a "contractor" if that person carries out activities, which are not: (i) petroleum extraction activities; or (ii) any activities consisting of the acquisition, enjoyment or exploitation of petroleum rights, (within the meanings in section 140), but are—

(a) exploration or exploitation activities in, or in connection with, which the contractor provides, operates or uses a relevant asset (see section 152C) in a relevant offshore service; or

(b) otherwise carried on in, or in connection with, the provision by the contractor of a relevant offshore service.

(3) A contractor provides a "relevant offshore service" if the contractor provides, operates or uses a relevant asset in, or in connection with, the carrying on of exploration or exploitation activities in controlled waters by the contractor or any other associated person.

(4) For the purposes of subsection (1)(a) each of the following is an "associated person"

(a) any person who is, or has been, connected with the contractor,

(b) any person who has acted, acts or is to act, together with the contractor to provide a service, and

(c) any person who is connected with a person falling within paragraph (a) or (b).

(5) A person does not act together with a contractor to provide a service by reason only of leasing an asset, to any person, which is provided, operated or used in the service.

(6) For the purposes of subsection (4) and (5) a person who acts as a trustee, agent or other conduit for another person shall be treated as if they were connected with that other person.

(7) In sub-section (1)(c), "tax advantage" means—

(a) a relief from tax or increased relief from tax;

(b) a repayment of tax or increased repayment of tax;

(c) the avoidance or reduction of a charge to tax or an assessment to tax; or

(d) the avoidance of a possible assessment to tax.

152B Restriction on hire of relevant assets

(1) The total amount that may be brought into account in respect of the payments for the purposes of calculating the company's ring fence income in an accounting period is limited to the hire cap.

(2) The “hire cap” is an amount equal to the relevant percentage of TC for the accounting period, subject to subsection (3).

(3) If payments in relation to which subsection (1) applies are also made, or to be made, by one or more other companies in respect of the relevant asset or part, the “hire cap” is to be such proportion of the amount mentioned in subsection (2) as is just and reasonable, having regard (in particular) to the amounts of the payments made, or to be made, by each company.

(4) In sub-section (2), subject to sub-section (6), “relevant percentage” means URFT / TD x PRA where—

URFT is the number of days in the accounting period that the relevant asset is provided, operated or used for the purposes of the company’s ring fence trade;

TD is the number of days in the accounting period; and

PRA is the percentage appropriate for the relevant asset, pursuant to section 152D.

(5) Accordingly, the relevant percentage is zero if the relevant asset is not provided, operated or used in the accounting period.

(6) If the accounting period is less than 12 months, the relevant percentage is to be proportionally reduced.

(7) In sub-section (3), TC is OC + CE.

(8) Unless subsection (10) applies, OC is the sum of—

(a) any consideration given for the acquisition of the relevant asset or part when it was first acquired by a lessor associated person, and

(b) any expenses incurred by a lessor associated person in connection with that acquisition (other than the costs of financing the acquisition).

This is subject to subsections (11) and (12).

(9) Subsection (10) applies if the relevant asset or part—

(a) is leased by a lessor associated person from a person who is not a lessor associated person, and

(b) has never been owned by a lessor associated person.

(10) OC is the sum of—

(a) the consideration that it is reasonable to suppose would have been given for the acquisition of the relevant asset or part, if it had been acquired by a lessor associated person by way of a bargain at arm's length at the time it was first leased as mentioned in subsection (9)(a), and

(b) the expenses (other than the costs of financing the acquisition) that it is reasonable to suppose would have been incurred by a lessor associated person in connection with such an acquisition.

This is subject to subsections (11) and (12).

(11) If the relevant asset or part was first acquired by a lessor associated person, or (as the case may be) first leased as mentioned in subsection (9)(a), before the beginning of the accounting period, OC does not include any part of the consideration mentioned in subsection (8)(a) or (as the case may be) (10)(a) that it is reasonable to attribute to anything that no longer forms part of the relevant asset or part at the beginning of the accounting period.

(12) If the relevant asset or part was first acquired by a lessor associated person, or (as the case may be) first leased as mentioned in subsection (9)(a), in the accounting period, OC for the accounting period is—

OC x (D - DBA) / D))

where—

D is the total number of days in the accounting period,

DBA is the number of days in the accounting period before the day on which the relevant asset or part was first acquired or first leased, and

OC is the amount given by subsection (8) or (as the case may be) (10).

(13) CE is capital expenditure on the relevant asset or part (other than capital expenditure in respect of its acquisition or the acquisition of a lease of it) incurred by a lessor associated person—

(a) after it was first acquired by a lessor associated person or (as the case may be) was first leased as mentioned in subsection (9)(a), and

(b) before the end of the accounting period.

This is subject to subsections (14) and (15).

(14) CE does not include any capital expenditure mentioned in subsection (12) that is—

(a) incurred before the beginning of the accounting period, and

(b) not reflected in the state or nature of the relevant asset or part at the beginning of the accounting period.

(15) If any capital expenditure mentioned in subsection (13) is incurred on a day in the accounting period, the amount of CE for the accounting period in respect of that capital expenditure is—

CEA x ((D - DBI) / D)

where—

D is the total number of days in the accounting period,

DBI is the number of days in the accounting period before the day on which that capital expenditure is incurred, and

CEA is the amount of that capital expenditure.

(16) In this section—

"relevant asset" has the meaning given by section 152C;

"lease" means (in relation to an asset):

(a) an agreement or arrangement under which payments are made for the use of or otherwise in respect of the asset; and

(b) it includes an agreement or arrangement under which the payments (or any of them) represent instalments of a purchase price or payments towards it;

but it does not include the lease of an asset to which section 106B(1) (*[Machinery and plant] on hire-purchase* etc.) applies unless section 152A(1)(c) applies; and

"lessee" and "lessor shall be construed in accordance with the meaning of "lease";

"lessor associated person" means–

(a) the lessor;

(b) a person who is, or has been, connected with the lessor; and

(c) a person who is connected with a person falling within paragraph (b), or acting together with the lessor or a person falling within paragraph (b) in relation to the lease of relevant asset.

152C Relevant assets

(1) In this Part "relevant asset" means an asset within subsection (2) which is of the requisite value.

(2) An asset is within this subsection if it is a structure (including a ship or other vessel) that--

(a) can be moved from place to place (whether or not under its own power) without major dismantling or modification, and

(b) can be used in connection with a ring fence trade.

(4) An asset is of the "requisite value" if its market value is £2,000,000 or more.

(5) The Commissioner may by regulations modify the meaning of "relevant asset" and "requisite value".

(6) Regulations under subsection (5) may--

(a) amend this section,

(b) make different provision for different cases or different purposes, and

(c) make incidental, consequential, supplementary or transitional provision or savings.

152D Hire cap percentages for relevant assets

(1) Subject to subsection (2), the percentage appropriate for a relevant asset shall be 7.5%.

(2) If , in the opinion of the Commissioner by notice to the company, a percentage other than 7.5% would be just and reasonable having regard to the economic characteristics of the relevant asset, including by reference to the useful economic life of the relevant asset when it was first constructed, such other percentage shall be the percentage appropriate for the relevant asset.

152E Hire of relevant assets – anti-avoidance

(1) If a person enters into arrangements the main purpose or one of the main purposes of which is to secure that section 152A(2) does not apply in relation to one or more payments to any extent, that provision applies in relation to the payments to the extent it would not otherwise do so.

(2) In subsection (1) "arrangements" includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable).

155D Hire of relevant assets – administration

(1) A company which leases a relevant asset shall submit, as part of that company's corporation tax return and accounts under section 30:

(a) an explanation of whether the restriction in section 152B applies to that lease; and

(b) to the extent it applies, a calculation of the amount of any restriction (including an explanation of how the value of TC has been determined, together with supporting evidence and the basis for any estimates used).

(2) A company shall promptly procure and provide such other information and copies of such documents as the Commissioner may by notice request for the purposes of assessing the compliance of the company with the restriction on hire of relevant assets including, but not limited to, details of the company's:

(a) leases of relevant assets;

(b) contractor services it has received;

(b) counterparties to their leases of relevant assets and contractor services; and

(c) commercial and tax purposes for entering into leases of relevant assets.

(3) If a company has not provided the return and information required by subsections (1) or (2) above, or if the return or information is deficient or has failed to comply with the relevant legislation, then the Commissioner may make such amendments to the return or an assessment as they see fit, and the Commissioner shall notify the company of such amendments.

(4) The submission of the matters in subsection (1) shall be required at the same time as and form part of a company's corporation tax return and accounts under section 30. The same consequences shall follow for a failure to submit the matters in subsection (1) as would follow from a failure to submit the company's accounts.

Matters for guidance

The draft legislation is influenced by the UK rules on the hire of relevant assets and FIGTO will generally follow the approach of HMRC when applying the legislation in practice. Please see below an indication of the points that would be covered in guidance, including reference to HMRC's manuals where relevant, by reference to the relevant sections of the legislation:

152A(4) – on the meaning of "associated person" and "acting together" see OT50020.

152B(3) – on just and reasonable apportionment where payments are made between more than one lessee see OT21610 and OT50036.

152B(8) – on establishing the original cost of an asset, and estimates where there is uncertainty, see OT50040 and OT50044.

152B(16) – for an explanation of the meaning of "lease" see OT50070 and OT21605. Note that a straight forward time charter, such as that created under a single contract for drilling, constitutes a service which uses an asset rather than a payment in respect of the use of a relevant asset. The provider of such a service would have a taxable presence in the Falkland Islands. Such a payment for services would not constitute a payment under a lease of a relevant asset within the hire of relevant assets legislation.

152C(2) – FIGTO would expect that any vessel or any other equipment which is leased would in principle be within the scope of the legislation, subject to the de minimis in section 152C(4).

152D(1) – the default relevant percentage of 7.5% has been formulated on the same basis as the UK legislation, see OT50032.

152D(2) – FIGTO would consider applications from taxpayers if they consider that a higher relevant percentage would be justified, for example where it can be shown that assets have a shorter useful life than 25 years. Applications should be supported by evidence and be accompanied with full details of the proposed leasing arrangements and the parties to those arrangements.