



November 2007

Tax Update

Petroleum mining changes considered

The Government released a consultative paper on 26 November 2007 seeking comments on a number of proposed changes to the tax treatment of petroleum mining expenditure. The consultative paper is the latest step in a package of measures announced by the Government in June 2004 to increase the level of petroleum and gas exploration and follows on from the launch of the New Zealand Energy Strategy in October this year.

The proposed changes are intended to clarify and remove current disincentives from the petroleum mining tax rules in pursuit of the Government's broader objective of encouraging sensible investment in oil and gas exploration and development. In summary, the consultative paper suggests:

- removing the distinction between onshore and offshore development so that deductions for development expenditure are allowed from the date the expenditure is incurred regardless of the location of the development
- introducing a "depletion method" as a alternative to the current seven-year straight-line method for amortising development expenditure
- allowing a petroleum miner who uses the depletion method of amortising development expenditure an immediate deduction for production well expenditure when the well is scrapped, or plugged and abandoned
- clarifying that GST input tax credits are allowed for site restoration costs that are associated with a past taxable supply notwithstanding that they may be incurred long after the taxable activity has ceased.

The consultative paper suggests that the proposed changes apply to petroleum mining expenditure incurred on or after 1 April 2008 and invites interested parties to make submissions on the proposals by 17 January 2008.

Removal of onshore-offshore distinction

Currently, development expenditure incurred in an offshore development are deductible from the date that the expenditure is incurred, whereas those incurred in an onshore development are not deductible until commercial production begins. The Government is concerned that the more favourable deductibility rules for offshore development may distort investment decisions and believes that the distinction is no longer sustainable in light of recent advances in horizontal drilling technology. Accordingly, the Government proposes to abolish the distinction and to allow deductions for development expenditure from the date that the expenditure is incurred, regardless of where the development is located.

Introduction of alternative method for amortising development expenditure

Development expenditure is currently amortised over seven years on a straight-line basis. Although this method has the advantage of being relatively simple and well understood by the industry, the concern is that it does not adequately approximate the actual decline in value of the fields with the result that income from some fields is being over-taxed, while income from other fields is under-taxed. Accordingly, the Government is considering introducing a new "depletion method" of amortising development expenditure and giving producers the choice of either the new method or the current seven-year straight-line method for amortising development expenditure in a field.

The key principle behind the depletion method is that development expenditure should be written off as oil and gas reserves are depleted. This allows the cost of a field to be written off over its useful life and the deductions to be matched with revenue from the field. Broadly, the amount of deduction allowed in an income year under the depletion method is equal to the total amount of unamortised development expenditure less the expected residual value of the field, multiplied by the proportion of petroleum production in that year relative to the estimated total reserves remaining at the beginning of the year.

The Government has suggested that the amount of "probable reserves" (reserves estimated to have a greater than 50 percent chance of being technically and commercially producible) be used as a measure for total reserves because investment decisions are often based on that amount. However, feedback is sought on whether this is an appropriate measure.

Where additional development expenditure is incurred during the life of a project or there is a change in the estimate of total reserves, the current suggestion is that adjustments should be made in the income year following the year in which the expenditure is incurred or the change in estimate occurs.

In principle, deductions under the depletion method cannot be claimed until production has commenced. The Government's solution is to allow petroleum miners the

option of applying the seven-year straight-line method until production begins, and then applying the depletion method to the amount of development expenditure remaining at the start of the income year in which production begins.

Deduction for expenditure on failed production wells

Currently, expenditure on failed production wells cannot immediately be written off unless the asset is sold or the relevant petroleum licence is relinquished. Although the Government intends to retain the status quo for miners who amortise development expenditure using the seven-year straight-line method, it is proposing to allow those that use the new depletion method to deduct the remaining tax book value of a production well in the year that the well is scrapped or plugged and abandoned.

GST input tax credits in respect of site restoration expenditure

Inland Revenue considers that the current GST rules do not allow input tax credits to be claimed for site restoration expenses if they are incurred a long time after the taxable activity to which they relate has ceased. The proposed changes would allow GST input tax credits to be claimed for site restoration expenses associated with a past taxable supply, regardless of whether the taxable activity has ceased.

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