OIL & GAS AND TAX & EXCHANGE CONTROL

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CLIFFE DEKKER HOFMEYR

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IN THIS ISSUE

Proposed changes to the taxation of oil and gas

On 17 December 2021 National Treasury (NT) issued a tax policy discussion paper (NT discussion paper) on "*What is the most appropriate tax regime for the oil and gas industry*?" The NT discussion paper sets out certain key proposals on the taxation of upstream oil and gas activities along with a request for comments thereon. In this article we draw attention to the key proposals made in the NT discussion paper along with some brief commentary where appropriate.

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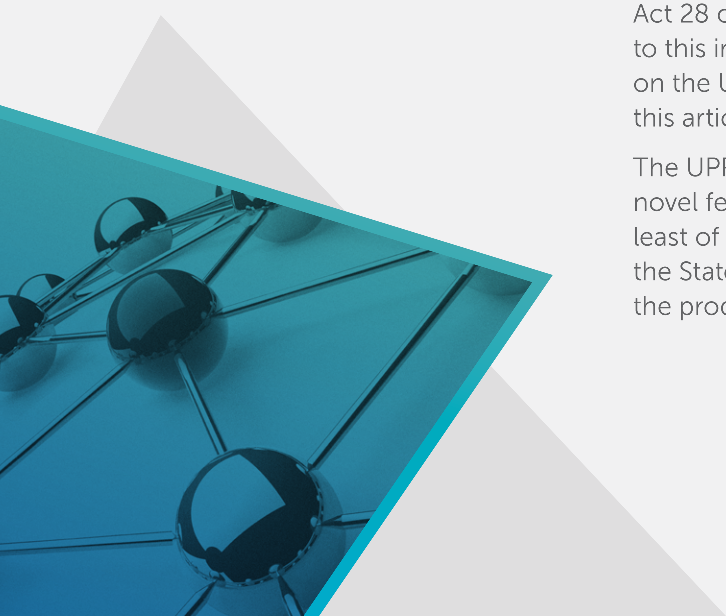

By way of background, the NT discussion paper follows previous announcements made by the Minister of Finance in the annual budget speech regarding possible changes in the taxation regime for oil and gas companies. The NT discussion paper also follows the tabling of the Upstream Petroleum Resources Development Bill (UPRD Bill), in Parliament on 1 July 2021 by the Minister of Mineral Resources and Energy. Once promulgated, the UPRD Bill will be the first piece of legislation that is dedicated solely to the State's participation in and regulation of the upstream oil and gas industry, and will replace those parts of the Mineral and Petroleum Resources Development Act 28 of 2008 which currently apply to this industry. Read our commentary on the UPRD Bill, linked at the end of this article.

The UPRD Bill includes a number of novel features and mechanisms, not least of which is that which grants the State a 20% "*carried interest*" in the production/revenue of an oil and gas project reduced by the State's proportionate share of exploration and production costs. The concept of "*carried interest*" is explained succinctly in the NT discussion paper and is essentially a means for the State to benefit from the proceeds of an oil and gas project without making any upfront cash investment. Under the carried interest participatory model, investors bear all the risk if no commercial discovery is made.

As an aside, the NT discussion paper should be commended for the amount of detail it provides *inter alia* on the full spectrum of fiscal instruments that can be applied to the oil and gas industry along with useful commentary on how these have been implemented in various foreign jurisdictions.

In relation to the "*carried interest*" participatory model, a key proposal made in the NT discussion paper is that the State's share of production/revenue should flow directly to the National Revenue Fund and should thus be administered and collected by the South African Revenue Service (SARS) as opposed to any other state-owned company or department of government. As motivation for this proposal the NT discussion paper diplomatically notes that shifting the flow of funds to a state-owned company may mean that revenue would be channelled away from potential enhancements to public spending and service delivery to the people of South Africa. It also argues that SARS is best placed to administer this stream of revenue due to its extensive experience in mining taxation.

Given recent and ongoing events in South Africa, particularly regarding state capture, it is difficult to argue against this proposal by NT. It must however also be noted that the UPRD Bill contemplates that the State will be an active JV partner to investors in oil and gas projects as opposed to passively collecting its fair share of production/revenue, and this will arguably still necessitate that

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a separate state owned company, one which will likely fall under the auspices and ownership of the Department of Mineral Resources and Energy, be involved in the strategic and operational management of oil and gas projects. The inter-related but separate roles of SARS and this state-owned company could present some interesting dynamics, and industry players are advised to make submissions to NT around any concerns in this regard.

The NT discussion paper contains another key proposal for a flat-rate royalty of 5% to be levied on the gross sales of oil and gas companies which is a significant deviation from the current royalty regime that imposes a royalty rate based on profitability. Along with this proposal, the NT discussion paper also proposes that no changes should be made to the current corporate income tax (CIT) regime for oil and gas companies. In formulating these proposals, NT should again be commended for the extensive research and simulation analysis as outlined in the NT discussion paper.

The primary motive for the proposal to move toward a flat-rate royalty is supposedly to enable the State to derive an upfront, stable source of revenue from the extraction of its finite resources, particularly given that the State's other shares of revenues derived from oil and gas projects, being its 20% carried interest and CIT, are based on profitability. However, one criticism of the NT discussion paper is that while the current, and extremely favourable, CIT regime allows oil and gas companies to generate significant assessed losses this will of course be mitigated by the proposed limitation on the use of assessed losses that should soon come into effect. The impact of this limitation on CIT collections is simply disregarded in the various simulations around total revenue collection in the NT discussion paper, which in turn undermines the argument for the imposition of a flat-rate royalty as a source of upfront revenue for the State given that the limitation on the use of assessed losses should in any event result in the State collecting tax revenue (in the form of CIT) much earlier than what the simulations in the NT discussion paper anticipate.

Furthermore, the proposal for a flat-rate royalty of 5% to be imposed should also be considered in the context of South Africa's oil and gas industry as a whole. In this regard, it is noted that South Africa's oil and gas industry remains an emerging industry where no significant and commercially exploitable finds have ever been made. Oil and gas companies are also being put under increasing pressure by environmentalists and other public activists to refrain from conducting certain exploratory activities.

The final key proposal made in the NT discussion paper to do away with fiscal stability agreements arguably only exacerbates the situation and further disincentivises oil and gas companies from conducting exploratory activities. Intuitively, one would think that if the State expects

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oil and gas companies to incur significant costs, including having to fund and be at risk for the State's proportionate share, in the ongoing and thus far futile pursuit of finding large and commercially exploitable reserves, and amidst growing public pressure, then these companies should instead be given as much certainty as possible regarding the State's share of taxes.

The primary justification provided in the NT discussion paper for doing away with fiscal stability agreements is seemingly due to the fact that the State has not approved any such agreements in the last seven years.

Unfortunately no indication is given in the NT discussion paper as to whether this is because no applications for such agreements have been made or because the State has simply ignored, disregarded, or declined any applications for such agreements in the past seven years. One is inclined to guess the latter, and industry players may do everyone a favour and make submissions to NT as to whether the lack of fiscal stability agreements could hinder the viability and growth of the developing oil and gas industry in South Africa.

LANCE COLLOP AND
MEGAN RODGERS

COMMENTARY ON THE UPSTREAM PETROLEUM RESOURCES DEVELOPMENT BILL

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OUR TEAM

For more information about our Oil & Gas sector and services in South Africa and Kenya, please contact:

Megan Rodgers
Sector Head
Director
Oil & Gas
T +27 (0)21 481 6429
E megan.rodgers@cdhlegal.com

Shameegh Allen
Associate
Corporate & Commercial
T +27 (0)21 481 6399
E shameegh.allen@cdhlegal.com

Gasant Orrie
Cape Managing Partner
Director
Corporate & Commercial
T +27 (0)21 405 6044
E gasant.orrie@cdhlegal.com

Amore Castens
Associate
Corporate & Commercial
T +27 (0)21 481 6432
E amore.carstens@cdhlegal.com

Njeri Wagacha
Partner | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E njeri.wagacha@cdhlegal.com

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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JOHANNESBURG
1 Protea Place, Sandton, Johannesburg, 2196.
Private Bag X40, Benmore, 2010, South Africa.
Dx 154 Randburg and Dx 42 Johannesburg.
T +27 (0)11 562 1000 F +27 (0)11 562 1111
E jhb@cdhlegal.com

CAPE TOWN
11 Buitengracht Street, Cape Town, 8001.
PO Box 695, Cape Town, 8000, South Africa.
Dx 5 Cape Town.
T +27 (0)21 481 6300 F +27 (0)21 481 6388
E ctn@cdhlegal.com

NAIROBI
Merchant Square, 3rd floor, Block D,
Riverside Drive, Nairobi, Kenya.
P.O. Box 22602-00505, Nairobi, Kenya.
T +254 731 086 649 | +254 204 409 918 |
+254 710 560 114
E cdhkenya@cdhlegal.com

STELLENBOSCH
14 Louw Street, Stellenbosch Central,
Stellenbosch, 7600.
T +27 (0)21 481 6400
E cdhstellenbosch@cdhlegal.com

CLIFFE DEKKER HOFMEYR

INCORPORATING
KIETI LAW LLP, KENYA

OUR TEAM

For more information about our Tax & Exchange Control practice and services in South Africa and Kenya, please contact:

Emil Brincker
Practice Head
Director
T +27 (0)11 562 1063
E emil.brincker@cdhlegal.com

Sammy Ndolo
Managing Partner | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E sammy.ndolo@cdhlegal.com

Lance Collop
Director
T +27 (0)21 481 6343
E lance.collop@cdhlegal.com

Mark Linington
Director
T +27 (0)11 562 1667
E mark.linington@cdhlegal.com

Gerhard Badenhorst
Director
T +27 (0)11 562 1870
E gerhard.badenhorst@cdhlegal.com

Jerome Brink
Director
T +27 (0)11 562 1484
E jerome.brink@cdhlegal.com

Petr Erasmus
Director
T +27 (0)11 562 1450
E petr.erasmus@cdhlegal.com

Dries Hoek
Director
T +27 (0)11 562 1425
E dries.hoek@cdhlegal.com

Heinrich Louw
Director
T +27 (0)11 562 1187
E heinrich.louw@cdhlegal.com

Howmera Parak
Director
T +27 (0)11 562 1467
E howmera.parak@cdhlegal.com

Stephan Spamer
Director
T +27 (0)11 562 1294
E stephan.spamer@cdhlegal.com

Tersia van Schalkwyk
Tax Consultant
T +27 (0)21 481 6404
E tersia.vanschalkwyk@cdhlegal.com

Louis Botha
Senior Associate
T +27 (0)11 562 1408
E louis.botha@cdhlegal.com

Keshen Govindsamy
Senior Associate
T +27 (0)11 562 1389
E keshen.govindsamy@cdhlegal.com

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E jhb@cdhlegal.com

CAPE TOWN
11 Buitengracht Street, Cape Town, 8001.
PO Box 695, Cape Town, 8000, South Africa.
Dx 5 Cape Town.
T +27 (0)21 481 6300 F +27 (0)21 481 6388
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NAIROBI
Merchant Square, 3rd floor, Block D,
Riverside Drive, Nairobi, Kenya.
P.O. Box 22602-00505, Nairobi, Kenya.
T +254 731 086 649 | +254 204 409 918 |
+254 710 560 114
E cdhkenya@cdhlegal.com

STELLENBOSCH
14 Louw Street, Stellenbosch Central,
Stellenbosch, 7600.
T +27 (0)21 481 6400
E cdhstellenbosch@cdhlegal.com

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INCORPORATING
KIETI LAW LLP, KENYA