Tax Alert

Taxation of the Oil and Gas Sector

PwC Business School

June 2014

A complete rewrite of the Ninth Schedule "the Schedule" is contained in the 2014 Finance Bill that has now been published. All players in upstream and midstream oil and gas subsector have been impacted by the revamped Schedule to the Income Tax Act. Changes to the Schedule also impact stakeholders in the mining and geothermal subsectors.

The revamped Schedule takes effect from 1 January 2015 subject to any changes that may be made by the National Assembly before the Finance Bill becomes an Act of Parliament.

Summary

Generally the proposed Schedule has attempted to remove inconsistencies between the Production Sharing Contracts (PSC's) and the Income Tax Act (ITA). The proposed changes have tried to align the tax provisions in the ITA with the tax provisions in the PSCs.

The changes have abolished the withholding tax (WHT) regime that was applicable on farm-out transactions and share sale transactions. This should be a welcome move as the oil and gas sector was being adversely impacted by the tax.

The revamped Schedule does not, however, deal with natural gas and its peculiar tax and accounting issues. New definitions have been introduced and existing ones expanded e.g. consideration, exploration and development costs, disposal, person, underlying ownership amongst others.

Any term that has not been defined in the ITA but has been defined in the Mining Act, Geothermal Resources Act or Petroleum Exploration and Production Act will take the meaning assigned in those Acts.

Key changes

We have highlighted key amendments that may have a significant impact on the oil and gas subsector:

Immovable property

The term "immovable property" has been defined to mean a mining right, an interest in a petroleum agreement, mining information or petroleum information.

Farm-out transactions

Assignment of rights

Currently, farm-out transactions are taxed at 10% or 20% of the gross consideration. With effect from 1 January 2015, such transactions will be taxed on the gain where the net gain will form part of the taxable income of the transferor and will be taxed at the corporation tax rate subject to certain restrictions.

Direct or indirect disposal of equity interest

Currently, taxation of indirect disposal of shares in petroleum companies was unclear, however, in the proposed Schedule the net gain in such transactions will be subject to tax in a manner similar to assignment of rights.In both instances the net gain will be subjected to tax based on the quantum of interest being assigned.

- Where the interest derived directly or indirectly from immovable property is below 20% of the total value of the interest, the net gain is not taxable.
- Where the interest disposed is between 20% - 50%, the net gain will be taxable using a prescribed formula
- Where the interest disposed is above 50%, the net gain will be fully taxable.

pwc

Welcome move towards harmonization with production sharing contracts and push for modernity

Taxes-paid PSC
The Schedule now recognises that the Government's share of production is inclusive of the taxes of the petroleum company. However, tax inclusivity is only with respect to the income arising from petroleum operations undertaken by the contractor.

Work obligations
The Schedule has clarified that work obligations taken up by the farmee i.e. buyer will not be considered to be part of the farm-out consideration and will be excluded from the net gain arising from farm-out transactions.

Blocks are now ring fenced
Ring fencing of petroleum blocks has been introduced and expenditure incurred in a particular block can only be offset against income derived from that block. This is in line with the model Production Sharing Contract (PSC).

Life cycle of petroleum activities distinguished
The Schedule now deals with the tax issues involved in each stage of the life cycle of petroleum activities. For instance during the exploration stage, capital expenditure incurred will be granted capital allowance of 100% in the year in which the expenditure is incurred.

Development expenditure has been defined to include capital expenditure incurred in undertaking operations authorized under a development plan including acquiring an interest in a petroleum agreement or petroleum information that has not been previously included in the exploration expenditure. This expenditure will be deductible upon commencement of production at a rate of 20% over a five year period.

Tax losses carried forward indefinitely
Restrictions on carry forward of tax losses are no longer applicable to Petroleum Companies - losses can now be carried forward indefinitely. The carry back of tax losses also apply for a maximum of three years.

However, it is unclear what will happen to non ring fenced losses (losses that arose before the Schedule comes into effect).

Thin capitalisation threshold reduced
Currently, an entity is considered to be thinly capitalised if it is under the control of a non-resident and the amount of debt exceeds three times the share capital of the company. This threshold has now been reduced to 2:1 (debt to equity) and an entity will be considered as thinly capitalised if it is under the control of a non resident and the amount of debt exceeds two times the share capital of the company.

Permanent establishments
Certain payments (such as interest, royalties and management fees) by a branch of petroleum company to its head office are no longer tax deductible.

Natural resource income
A payment for a natural resource is subject to withholding tax at 5% or 20% depending on the residence status of the recipient of the consideration for the right to take a mineral or living or non-living resource from land or sea. The withholding tax applies to an amount calculated with reference to the quantity or value of minerals or living or non-living resource taken from land or sea. The withholding tax does not, however, apply if the recipient of the nature resource income is exempt from income tax.

Hedging transactions
Where a petroleum company enters into a hedging transaction to manage commodity price risk, this will be treated as a specified source of income except in cases where the hedging transaction has been approved by the Commissioner and the petroleum contractor has an annual turnover of less than ten million shillings.

Social infrastructure
Social infrastructure expenditure (eg public schools, hospitals) will be tax deductible subject to approval by the Cabinet Secretary for the National Treasury.

Decommissioning expenditure
Expenditure incurred in abandonment and decommissioning of petroleum operations will be deductible only when it is funded by the contractor and funds are transferred by the contractor to an escrow account or when the expenditure is incurred by the contractor under an approved decommissioning plan.

Indirect transfers of interest
A contractor is required to notify the Commissioner (in writing) immediately if there is a change of ten per cent or more in the underlying ownership of the contractor.

Mid-stream activities

Petroleum pipeline equipment will qualify for capital allowances at the rate of 37.5% per year on a reducing balance.

Subcontractors

The term 'subcontractor' has been defined to include resident persons (individual, company, partnership, trust or government) supplying services to a contractor in respect of petroleum operations.

Subcontractors who are non-resident (and do not have a permanent establishment in Kenya) will be subject to withholding tax at the rate of 5.625% (which is final tax) on the gross amount of the service fee.

There is no mention of the exclusion of reimbursements and disbursements from the services fee. Note that subcontractors with a permanent establishment in Kenya will be taxed at a rate of 37.5% on adjusted profit.

The subcontractor is now required to prepare financial statements and compute the applicable taxable income. In addition the proposed Schedule does not specifically exclude reimbursements and disbursements from the service fees charged by a sub-contractor to the petroleum company.

Withholding tax

The proposed Schedule stipulates that there is a withholding tax on dividends paid by a petroleum company and yet the model PSC specifically exempts dividends from taxation.

The withholding tax rates applicable on payments to non residents are shown in the table below:

Payment	WHT Rate	
	Existing	*Proposed*
Dividends	0%	10%
Interest	10%	15%
Royalties	20%	20%
Natural Resource Income	-	20%
Management or Professional Fees	12.5%	12.5%

The withholding tax rates applicable on payments to resident entities remain the same, however the Bill has introduced withholding tax at the rate of 5% on natural resource income payments to resident companies.

However, the distinction between a non-resident provider of management or professional fees and a sub-contractor is not clear, which will complicate the application of withholding tax.

Conclusion

The revamped Schedule is a welcome move and is a sure step towards modernity and harmonization with the PSC's.

The changes are also a move towards harmonizing the legislation with that of the rest of the East African Community.

Taxation of natural gas has however not been addressed in the Bill. It could be that in future, a standalone Oil and Gas Act divorced from the ITA will be enacted.

This bulletin highlights the changes as contained in the Finance Bill 2014. There is an opportunity for public participation before the Bill is enacted before the end of 2014.

Should you require clarification or guidance please contact.

Steve Okello
Partner
+254 20 285 5000
steve.x.okello@ke.pwc.com

Osborne Wanyoike
Senior Manager
+254 20 285 5000
osborne.wanyoike@ke.pwc.com

or your usual PwC contact.