and assessment rules, and possibly a bespoke collection mechanism. The proposals would have to be the subject of detailed consultation, before it was possible to prepare draft legislation.

The operational work, especially the IT systems, necessary to implement the new tax could not be commenced until the second reading of the Finance Bill containing the draft legislation. The measure would consume scarce policy capacity in the Treasury and HMRC at a time when their resources are fully committed to Brexit, and distract HMRC's IT and operational teams from delivering previously announced measures, including the new customs declaration service. It would probably take at least three years before a brand new tax was fully operational. We would be in the run-up to the next general election by the time the tax was introduced.

The proposed tax would probably be dismissed as a 'gimmick'. It would not be able to raise revenues remotely rivalling those collected through income tax, NICs or VAT. The yield expected from the new tax could be collected far more easily and cheaply by simply marginally increasing the rate of income tax or NICs or VAT.

Workers over state pension age

Andrew Dilnot, the chairman of the Independent Commission on the Funding of Social Care and Support, has recently suggested that the million plus workers over the state pension age who are still employed or self-employed should cease to be exempt from NICs.

The logic behind the exemption of those over state pension age from NICs is supposed to be that they can 'leave the club' once they become *entitled to draw* their state retirement pension. But there is a principled case for removing the age exemption to NICs being charged on the earnings of those who choose to continue working past the state pension age. Pensioners are the biggest users of health and social care services. More than 40% of pensioners are now in the top half of income distribution. Many don't need the full range of non-means tested benefits available to pensioners. It would help to address the intergenerational dislocation created by the rapidly rising increase in the dependency of older citizens on the working age population. (The ONS estimates that the number of people over the age of 65 years will increase by 7m by 2046, while the number of working age workers will rise by only 3m.) But the influence of the 'grey vote' might make the government wary of risking a row with its own backbenchers over the perfectly sensible change.

Hysteresis

In economics, 'hysteresis' refers to effects that persist after the initial causes giving rise to the effects are removed. (The word is derived from a Greek verb meaning, 'that which comes later'.) The funding problems of the NHS are likely not just to recur, but to get worse if the government fails to come up with a credible mechanism to keep funding apace with demand for NHS services. If it is necessary for NHS funding to be continually re-addressed whenever its crisis becomes too serious to ignore, the amount of the top-up required the next time would be greater. ■

A longer version of this article is available on taxjournal.com.

Analysis

Distress in North Sea oil and gas assets: tax traps for the unwary

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Speed read

Low oil prices have opened up opportunities for investment funds and other non-bank lenders to invest in companies operating on the UK Continental Shelf. However, investors should note the potential bear traps which can arise in connection with holding a debt and/or equity stake in such companies. These include: potential non-resident capital gains tax charges for both equity and debt holders; 'hidden' decommissioning costs, which arise where the company has provisioned for decommissioning costs on a post-tax basis but has no capacity to benefit from any tax relief; and difficulties in preserving carry-forward losses on a sale, as well as more general UK tax issues which can apply to the restructuring of debt owed by any UK company.

Many highly leveraged oil and gas companies have suffered from the persistently low oil prices of the last few years, leading to the price of their debt dropping to distressed levels. This has opened up opportunities for investment funds and other non-bank lenders to purchase debt at discount prices, with the possibility of debt prices significantly increasing as oil prices rise or the issuer otherwise improves its creditworthiness. If the company's financial situation has got to the point that a financial restructuring is required, as part of which creditors may swap a portion of their debt for an equity stake, there is also the added allure of the valuable tax losses that these companies will almost inevitably have on their balance sheets. However, while the special tax regime that applies to North Sea oil and gas companies contains a number of preferential features, there are also a number of potential bear traps for the unwary.

The modified oil and gas tax regime

Companies producing oil and gas on the UK Continental Shelf are subject to a modified corporation tax regime in respect of their oil-related activities (as defined in CTA 2010 s 274). Profits from such activities are subject

to higher tax rates and 'ring-fenced', in order to prevent losses from other activities being used to reduce oil-related taxable profits. The ring fence corporation tax (RFCT) rate is currently 30%. In addition, a supplementary charge (SC) is levied, currently at 10%, although the rate has been adjusted a number of times since SC was introduced, often in response to material changes in the price of oil. SC is calculated in the same way as corporation tax, but with no deductions for financing costs. The higher overall tax rate of 40%, compared to the corporation tax rate of 19%, is to some extent offset by generous allowances intended to encourage investment, such as 100% first year capital allowances and an investment allowance which reduces any SC by 62.5% of 'investment expenditure'. Furthermore, ring fence profits are excluded from the new regimes restricting the use of carry-forward losses and the deductibility of interest.

Fields that received development consent prior to 16 March 1993 are also subject to petroleum revenue tax (PRT). This is charged at 0% for chargeable periods ending after 31 December 2015, and so should not increase a company's tax burden, but may still be relevant in respect of historic accrued losses (as discussed further below).

Non-resident capital gains tax

A non-UK resident is usually only subject to UK capital gains tax, or UK corporation tax on chargeable gains, if it carries on a trade through a UK permanent establishment; and if the gain arises in respect of assets situated in the UK which are used for the purposes of that trade or establishment (although there are special rules for non-UK resident companies holding UK residential property, which are expected to be significantly expanded from 2019). However, TCGA 1992 s 276 effectively extends this rule, such that a disposal of unquoted shares which derive more than half their value directly or indirectly from UK oil rights are brought within the scope of UK tax, regardless of the tax residence of the seller. Consequently, any gain arising on the sale of shares in an unlisted North Sea oil and gas company may be subject to a charge under s 276 if the conditions of the UK's substantial shareholding exemption are not satisfied. For these purposes, it is important to note that shares listed on the London Stock Exchange's Alternative Investment Market will constitute 'unquoted shares'.

Perhaps more pertinent to the distressed debt context is the fact that the definition of 'shares' in s 276 includes 'stock and any security'. The broad definition means that a non-UK resident creditor is potentially within the charge in respect of the sale of a debt which derives more than half of its value directly or indirectly from oil exploration or exploitation. Given that, in most cases, the debt will be repaid using the proceeds of such activities, this is a point that existing and potential lenders to North Sea oil and gas companies would be advised to bear in mind. In practice, the charge may not apply on the disposal of the debt because a UK tax exemption applies; for example, the transaction may fall within the capital gains reorganisation provisions, or the security may constitute a 'qualifying corporate bond' (QCB). (While loan relationships of companies are QCBs, the QCB exemption may be unavailable where the lender is a partnership and the debt is denominated in a currency other than sterling.)

No s 276 charge should arise where the debt is listed (and therefore the security is not unquoted); and, depending on the seller's activities, it may alternatively be possible to argue that the loan is held on trading (and not investment) account and, as such, should not give rise to a chargeable gain in the first place. Depending on the circumstances of the seller, and the terms of the debt, there may be other reasons why the s 276 charge does not apply.

If, however, a s 276 charge is expected to apply under UK domestic law, it may be possible to rely on an applicable double tax treaty to restrict the UK's taxing rights. However, it will be important to check the terms of the particular treaty. The US/UK treaty, for example, preserves the UK's rights to tax capital gains arising from unquoted shares deriving a greater part of their value from real property (including oil rights) situated in the UK (including the UK Continental Shelf). (While 'shares' is not defined in the treaty itself, article 3(2) indicates that, in such circumstances, the domestic law interpretation should be adopted.) As such, the US/UK treaty will only provide protection to the extent that the value of the shares are attributable to assets that are not 'real property', as defined in the treaty (for example, mobile rigs).

Where investors are seeking to benefit from profit or revenue sharing arrangements, it may be necessary to consider whether such rights could bring an investor within the scope of s 276. Similarly, there is a risk that such arrangements could result in a non-UK investor being deemed to have a UK permanent establishment, if they are regarded as holding 'exploration or exploitation rights' or as receiving profits from 'exploration or exploitation activities' within CTA 2009 s 1313; and for any investor to become subject to the ring-fence regime if they are regarded as carrying on 'oil-related activities' within CTA 2010 s 274. Depending on the nature of the arrangements, it may also be necessary to consider whether such payments are subject to withholding on account of being annual payments.

'Hidden' decommissioning costs?

A particular feature of oil and gas assets is their need to be decommissioned at the end of their life. In this regard, tax relief on decommissioning costs may be significant. If decommissioning costs produce an overall loss for a year, those losses can be carried back against previous ring fence profits as far as 2002 for RFCT and SC, and indefinitely for PRT, provided that the company has sufficient tax history (i.e. previously taxed upstream profits against which to set those losses).

Owners of oil and gas rights are typically required to post security for the cost of decommissioning. Notwithstanding the potential for generous tax reliefs, such security was historically provisioned for on a pre-tax basis, taking no account of any potential tax relief that a participant might be able to obtain, as there was no certainty that the government would not change the rules as to the value and nature of the tax relief available before the decommissioning costs were incurred. The government responded by introducing decommissioning relief deeds (DRDs) – bilateral agreements between the government and particular taxpayers – which are intended to provide more certainty as to the tax relief that will be available for decommissioning expenditure in particular circumstances. As a result, it is now quite common to see decommissioning liabilities provisioned for on a post-tax basis.

However, the introduction of DRDs has not affected the rule requiring a company to have sufficient tax history to benefit from the available tax relief. As such, if a company has provisioned on a post-tax basis but has never been in a taxpaying position (or, to the extent it has, those taxable profits have already been set off against losses), there is

likely to be a significant shortfall in the provisioning for decommissioning costs, even if the company has posted security in accordance with the decommissioning security agreement. This has the potential to cause the company cashflow issues once decommissioning begins. It is also likely to make it more difficult to sell late-life oil and gas assets, as only companies with sufficient tax history to benefit from tax relief on the full decommissioning costs are likely to be willing to purchase such an asset. The government's recent proposal to introduce the concept of a transferable tax history in this sector is unlikely to assist in a situation where the seller does not have sufficient tax history to transfer to a buyer.

This is likely to be less of an issue in respect of PRT – which is a tax charged by reference to a particular field, rather than a particular taxpayer – as FA 1980 Sch 17 para 15 should operate to allow losses of a current participator to be set off against chargeable profits earned by a previous participator, and the current participator will generally have the right to receive any refund triggered by its own expenditure under the sale and purchase agreement for the licence from the previous participator.

Extracting value in respect of losses

Oil and gas companies with debt that has fallen to distressed prices are likely to have accrued significant losses on their balance sheet. Given the higher tax rates applicable to ring fence activities, investors will often be interested to understand whether, and how, value might be realised in respect of those losses. Unfortunately, however, there is now limited scope to sell or otherwise obtain value for accrued losses.

It has historically been common practice to 'hive down' a particular oil or gas asset into a new subsidiary and, relying on rules relating to the transfer of a trade or part trade to companies under common ownership, transfer the losses relating to that trade into the new subsidiary. That company is then sold to a third party buyer which can benefit from the transferred losses, provided that there is no 'major change in the nature or conduct' of the transferred trade (MCINOCOT) within a specified period for the purposes of the rules in CTA 2010 Part 14. However, HMRC does not as a matter of general policy provide assurance on the MCINOCOT rules. Given the uncertainty as to whether the transferred losses could be lost as a result of the MCINOCOT rules, buyers are often reluctant to allocate significant value to the losses being transferred.

In light of recent changes to the rules, which extended the period after the change in ownership in which a 'major change' can have an impact on transferred losses from three to five years, HMRC has indicated in the minutes of an expert panel on the tax issues for late-life oil and gas assets) that HMRC may be willing to offer a view on the application of the MCINOCOT rules in the oil and gas context (see section 4 of the August 2017 minutes of the inaugural meeting of the expert panel on tax on late-life oil and gas assets, at bit.ly/2GNXneZ). Such a clearance may provide soft comfort to a buyer, although this will need to be weighed against the increased period for which the rules apply. In addition, to the extent that the acquired asset ceases production during the five year period, this is likely to be regarded as a cessation of the transferred trade, which could extinguish any remaining transferred losses. It should also be noted that a hive down may expose a buyer to secondary liabilities in respect of the seller's decommissioning liabilities under the Petroleum Act 1998, as the buyer will effectively be buying an 'associated company' of the seller (even if that company is a new entity with a single asset).

Many buyers of oil and gas assets are therefore likely to prefer the certainty of an asset purchase where all or a substantial part of the consideration is allocated to plant and machinery. Such an allocation should allow a buyer unconnected with the seller to benefit from 100% first year allowances or mineral extraction allowances, thereby generating new losses which are not subject to the MCINOCOT rules.

It is also worth noting that the MCINOCOT rules can apply on a debt/equity swap to the extent that creditors are issued sufficient equity to trigger a 'change in ownership' for the purpose of the rules. Where a change in ownership has occurred, care must be taken to ensure that there are no 'major changes' to the business if carry-forward losses are to be preserved.

General UK tax issues on a debt restructuring

Potential investors should also note that a number of other UK tax issues, which apply more widely to all UK tax resident companies, may also arise in the context of a restructuring of the debt. For example, where the restructuring involves the release (or deemed release) of debt, a tax charge may arise to the debtor company unless a particular exemption applies. In this context, however, there are a number of exemptions designed to aid 'corporate rescues', where it is reasonable to assume that (in the absence of the release and associated arrangements) there would be a material risk that the debtor would be unable to pay its debts in the following 12 months, or where the release occurs as part of a statutory insolvency arrangement. There is also an exemption for certain debt for equity swaps.

Changes to the terms of a debt instrument falling short of a reduction in principal amounts owed could also have tax implications. UK companies which prepare their accounts in accordance with Financial Reporting Standard 102 are required to account for any 'substantial modification' of a financial liability as the cancellation of the original liability (i.e. the original liability is derecognised in the borrower's accounts) and the recognition of a new financial liability. In the case of a modification of distressed debt, this may result in accounting profit being realised by the debtor company, reflecting a relaxation of the terms of the debt (such as a change in interest rate, an extension of the maturity date, a softening of covenants) and/or a deterioration in the debtor's creditworthiness. The 'corporate rescue' tax exemption may, however, remove a corresponding tax charge, depending on the circumstances.

Non-UK investors should also be aware that the UK imposes withholding tax at 20% on yearly interest which is regarded as arising in the UK. However, if the debt has been listed on a recognised stock exchange, then (in addition to there being an exemption from the s 276 charge discussed above), there is also an exemption from UK withholding tax on interest. Alternatively, to the extent that such investors are eligible to rely on a relevant double tax treaty, the withholding tax may be reduced or extinguished.

Where the debtor is a UK incorporated company, stamp duty or stamp duty reserve tax at 0.5% of the consideration will also generally apply on a transfer of, or agreement to transfer, shares in that company, subject to the availability of any exemptions or reliefs. ■