EXPLANATORY MEMORANDUM TO

THE INVESTMENT ALLOWANCE AND CLUSTER AREA ALLOWANCE (INVESTMENT EXPENDITURE) REGULATIONS 2017

2017 No. 292

1. Introduction

1.1 This explanatory memorandum has been prepared by HM Revenue & Customs ("HMRC") on behalf of HM Treasury and is laid before the House of Commons by Command of Her Majesty.

1.2 This memorandum contains information for the Select Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 The investment and cluster area allowances, set out in Part 8 of the Corporation Tax Act 2010, currently provide tax relief for investment in the form of capital expenditure on oil extraction activities within the UK Continental Shelf ("UKCS"). This instrument extends the scope of the investment and cluster area allowances to include certain types of operating and leasing expenditure to encourage greater commercial investment in the UK's oil and gas industry.

3. Matters of special interest to Parliament

Matters of special interest to the Select Committee on Statutory Instruments

3.1 This instrument has effect in relation to any expenditure that is incurred from 8th October 2015, which is before the instrument comes into force. Authority for retrospective effect is provided by the powers in section 332BA(2) and section 356JE(2) of the Corporation Tax Act 2010. This instrument is the first use of the powers in section 332BA(1)(b) and section 356JE(1)(b) to prescribe that expenditure other than capital expenditure is investment expenditure for the purposes of investment and cluster area allowances.

Other matters of interest to the House of Commons

3.2 As this instrument is subject to negative resolution procedure and has not been prayed against, consideration as to whether there are other matters of interest to the House of Commons does not arise at this stage.

4. Legislative Context

4.1 The investment and cluster area allowances were inserted into Part 8 of the Corporation Tax Act 2010 by Finance Act 2015. Section 332BA and section 356JE give the meaning of investment expenditure for the purposes of investment allowance and cluster area allowance respectively. For both allowances it means capital expenditure or other expenditure prescribed by regulations. These regulations specify which other types of expenditure are investment expenditure.

5. Extent and Territorial Application

5.1 The extent of this instrument is the United Kingdom.

5.2 The territorial application of this instrument is the United Kingdom.

6. European Convention on Human Rights

6.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

What is being done and why

7.1 The oil and gas industry has been operating in the UKCS since the late 1960s. Currently, the UKCS's mature nature and the difficult operating conditions faced in the North Sea result in high operating costs for the extraction of oil and gas. Since 2014 the UK's oil and gas industry has experienced significant challenges including the price of oil falling to less than half its pre-2014 value and the loss of thousands of jobs within the sector.

7.2 In December 2014 the Government published a strategy to reform the oil and gas fiscal regime in the document 'Driving Investment: a plan to reform the oil and gas fiscal regime[1]'. This strategy set out the Government's commitment to maximise the economic recovery of the UK's hydrocarbon resources through reducing the overall tax burden experienced by the oil and gas industry.

7.3 Within this context the Finance Act 2015 built on the commitments set out in 'Driving Investment' by reducing oil and gas related tax rates and introducing the investment and cluster area allowances. The investment and cluster area allowances support the oil and gas sector by reducing the amount of ring fence profits taxed by the supplementary charge (a direct tax on oil and gas extraction activities). Prior to these regulations having effect, the investment and cluster area allowances were only available in relation to capital expenditure, for example on the purchase of an asset.

7.4 Extending the scope of the investment and cluster area allowances is expected to encourage new investment in the UK oil and gas sector as it provides tax relief on some operating and leasing expenditure on qualifying (i.e. new) oil fields or projects. Qualifying operating expenditure must be for a specified activity, not routine repair and maintenance, and qualifying leasing expenditure must be for the lease of a mobile oil production or storage asset for 5 years or more.

7.5 The provisions in regulations 5, 6 and 7 of the instrument, which are described below, prevent certain types of expenditure from generating the allowances, preventing opportunities for tax avoidance. The provisions in regulations 5 and 6 will only operate in relation to specified asset leases so their application is limited.

7.6 The restriction in regulation 5 ensures that the allowance generated matches the genuine economic value of the investment. As a result, some operating and leasing expenditure which would otherwise generate one of the allowances will not qualify. This regulation will prevent the allowances from being generated where the company

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/382785/PU1721_Driving_investment_-_a_plan_to_reform_the_oil_and_gas_fiscal_regime.pdf

or an associated company has previously received payments in respect of a lease which generated one of the allowances. This could include sale proceeds or a refund on termination of a lease. The amount of any such payments previously received will be set against any subsequent operating or leasing expenditure incurred, so that the allowances will only be generated by the excess expenditure.

7.7 The ability of lease payments made under a sublease to generate the allowances is capped in regulation 6. The level of the cap is set at the value of payments made under the head lease during the period of the sublease. Any payments made under a sublease which exceed this cap will not generate the allowances. This will only apply where the sublease is entered into or modified after the date this instrument comes into force, to prevent interfering with existing commercial arrangements and ensure companies are able to operate the cap effectively. This cap will ensure that excessive allowance is not generated where a sublease is entered into.

7.8 Regulation 7 prevents expenditure from generating the allowances when it is incurred in relation to arrangements which are designed to create a specified tax advantage. The targeted tax advantages could be generated by enabling expenditure to be treated as investment expenditure when it otherwise would not have been, generating allowance which would otherwise not have been generated, or changing the timing of when the allowance would have been generated or the expenditure incurred.

7.9 This instrument has effect in relation to expenditure incurred from 8th October 2015. This is the date that HMRC published a document setting out the scope of the extension to investment expenditure. The retrospective extension of the allowances will enable companies to benefit from the extended allowances for expenditure incurred while the regulations were being finalised. As a result, companies' ability to claim the allowances will not ultimately be affected by the additional time taken to finalise regulations 5, 6 and 7.

Consolidation

7.10 This is the first instrument made under these powers so consolidation is not relevant at this time.

8. Consultation outcome

8.1 Following representations from the oil and gas industry, HMRC published a scoping document on the 8th October 2015[2] before publishing a draft version of this instrument in December 2015[3]. Comments were invited during a period of six weeks to January 2016. Six written responses were received. The written responses showed strong support for the extension of the investment and cluster area allowances and a focus by commenters on technical issues. While a formal consultation response was not issued, changes were made to the draft legislation in response to some of these comments. Regulations 5 and 6 were also added following the consultation to address potentially unfair outcomes made possible by extending the allowances to leasing expenditure. There has not been a consultation on the further changes made as the time taken to finalise these regulations has delayed companies being able to benefit from the allowances. A second round of consultation would have delayed this further.

[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/466944/Expansion_of_investment_expenditure.pdf

[3] https://www.gov.uk/government/publications/draft-legislation-investment-allowance-for-oil-and-gas-companies

In addition, regulation 6 will also only have effect for sub-leases taken out after the date the regulations come into force, to avoid interfering with existing commercial arrangements. As a result, there would have been a risk of forestalling if this had been shared in advance.

9. Guidance

9.1 Draft guidance will be shared with industry for comment. Finalised guidance on these changes and the types of expenditure that qualify for allowance will be published in the online Oil and Gas Tax Manual[4].

10. Impact

10.1 There is no impact on charities or voluntary bodies. The extension of the investment and cluster area allowances will affect only oil and gas companies and is expected to have a positive impact on oil and gas companies' post-tax profits within the UK.

10.2 As a result of the delay in finalising the instrument, there may be an administrative cost to companies as they will need to submit amended corporation tax returns to claim the allowance for the first accounting period covered by the instrument.

10.3 There is negligible impact on the public sector.

10.4 A Tax Information and Impact Note covering this instrument was published on 16th December 2015 alongside draft legislation explaining changes to the investment and cluster area allowances and is available on the website at https://www.gov.uk/government/collections/tax-information-and-impact-notes-tiins. It remains an accurate summary of the impacts that apply to this instrument.

11. Regulating small business

11.1 The legislation does not apply to activities that are undertaken by small businesses.

12. Monitoring & review

12.1 The changes introduced by this instrument will be consistently monitored and reviewed by HMRC within the context of the oil and gas tax regime.

13. Contact

13.1 James Marshall at HM Revenue & Customs, Telephone: 03000 594912 or email: james.marshall1@hmrc.gsi.gov.uk can answer any queries regarding the instrument.

[4] https://www.gov.uk/hmrc-internal-manuals/oil-taxation-manual