

**THE EFFECTIVENESS OF THE TENTH SCHEDULE TAX REGIME TO
ATTRACT AND RETAIN FOREIGN INVESTMENT:
THE CURRENT ISSUES AND UNCERTAINTIES EXPERIENCED WITHIN THE
TENTH SCHEDULE TAX REGIME AND A COMPARISON BETWEEN THE
INCENTIVES PROVIDED BY THE TENTH SCHEDULE AND THOSE PROVIDED BY
THE GHANA OIL AND GAS TAX REGIME**

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BYNHER001

A dissertation submitted to the Department of Taxation, University of Cape Town, in partial fulfilment of the requirements for the degree of Masters of Commerce specialising in Taxation in the field of South African Tax.

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ABSTRACT

Interest in South Africa's offshore oil and gas potential is on the rise. In the last three years nearly all of the South African offshore acreage has been licensed and substantial offshore exploration is therefore expected in South Africa within the next few years (Petroleum Agency SA, 2015).

Exploration is a medium to long term exercise, one which is extremely costly (Futter, 2010:1) and the oil and gas industry therefore requires stable long term investment. The use of foreign direct investment will result in international oil and gas companies providing the technical skilled labour and finance which is required in order to maintain, upgrade and develop facilities in the oil and gas sector (PWC, 2014: 38). Foreign direct investment therefore plays an important role in this industry. Countries are in competition with one another to attract the required foreign investment.

In South Africa, oil and gas companies are subject to the ordinary tax rules within the Income Tax Act 58 of 1962 ("the Act"), but enjoy certain tax concessions within the Tenth Schedule to the Act. The main reason for introducing the Tenth Schedule was to create certainty and transparency for oil and gas exploration and production with the aim to secure foreign investment (National Treasury, 2006:15).

Considering the growth potential of South Africa's oil and gas industry and the fact that the Tenth Schedule was introduced to create certainty and transparency in the hopes of securing foreign investment, this dissertation evaluates whether the Tenth Schedule achieves its aim of providing certainty and transparency in order to attract and retain foreign investment in the oil and gas industry. Furthermore, this dissertation identifies issues and uncertainties found within the Tenth Schedule which could hinder such foreign investment. Finally, as countries are in competition with one another to attract foreign investment, this dissertation evaluates how the incentives provided by the Tenth Schedule compare to the incentives provided by Ghana's oil and gas tax regime.

The findings of this dissertation are that the Tenth Schedule contains a number of very attractive incentives and while some further consideration and clarification is needed in respect of the issues identified, the issues do not create overall uncertainty or instability to such an extent that it would substantially hinder foreign direct investment. The Tenth Schedule would therefore still achieve its aim of providing certainty and transparency in order to attract and retain foreign investment. In respect of the comparison performed between the incentives provided by the Tenth Schedule and those provided by the Ghana oil and gas tax regime, the findings of this dissertation are that both South Africa and Ghana have attractive tax incentives and both countries provide fiscal stability within their tax regimes which aims to create the stable investment environment required by investors. However, it appears that, from a foreign investor's point of view, South Africa has more favourable and attractive tax incentives than Ghana.

DECLARATION

I, Hermana Magrietha Mausling, hereby declare that the work on which this research paper is based is my original work (except where acknowledgements indicate otherwise) and that neither the whole work nor any part of it has been, is being, or is to be submitted for another degree in this or any other university. I authorise the University to reproduce for the purpose of research either the whole or any portion of the contents in any manner whatsoever.

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ABBREVIATIONS

CIA	Central Intelligence Agency
FDI	Foreign direct investment
GNPC	Ghana National Petroleum Corporation
MPRDA	Mineral and Petroleum Resources Development Act 28 of 2002
OECD	Organisation for Economic Co-operation and Development
Petroleum Income Tax Law	The Petroleum Income Tax Law 1987 (P.N.D.C.L. 188)
Royalty Act	Mineral and Petroleum Resources Royalty Act 28 of 2008
The Act	Income Tax Act 58 of 1962
The Tenth Schedule	The Tenth Schedule to the Income Tax Act 58 of 1962
UNCTAD	United Nations Conference on Trade and Development

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1. CHAPTER 1 - INTRODUCTION

1.1 Background

1.1.1 The oil and gas industry

Oil resources and extraction holds strategic significance for governments and the global economy. Exhaustion of oil reserves could jeopardise the existence of governments in some jurisdictions and has the potential to have a global economic impact. Significant concerns over the exhaustion of oil reserves remain ever present (Yergin, 2012:229 – 233). The oil and gas industry has some distinct features which sets it apart from most other industries. These include size of investment, risk, cost of failure, size of reward, level of employment, role of international markets and the non-renewable nature of hydrocarbon mineral resources. Government is therefore likely to formulate a tax policy or tax regime specifically for the oil and gas industry (Futter, 2010:1).

In addition to the above mentioned distinct features, the oil and gas industry is likely to receive special treatment as the discovery and production of oil and gas has the potential to decrease a country's dependency on external sources to satisfy its energy need. The discovery of oil and gas will also lead to substantial foreign revenue for the country (Clegg & Steenkamp, 2007:1). Foreign revenue or investment generates a number of benefits to a country. One of these benefits is the improvement of efficiency through the foreign companies' technology, knowledge and positive externalities. Another benefit is that foreign investment provides finance which leads to a reduced financial relationship between local companies and government. Ultimately, the additional benefits will result in increased productivity (Moolman, 2012:11).

The exploration and production of oil and gas entails a number of different activities. These activities include geological surveys, identifying the oil and gas resources and exploiting these resources. Tordo (2009:1) identifies the following risks within the previous mentioned activities:

“Geological – related to the likelihood that oil/and or gas are present in a particular location, and to the range of potential discoveries;

Financial – related to project and economic variables; and

Political – specific to each region or country.”

According to Tordo (2009:2), after an actual discovery has been made the geological risk will reduce, whereas the financial and political risk will deepen. Once the production of the natural resource commences the capital investment, with regards to the initial exploration, is a sunk cost. It is at this stage that the investor is vulnerable to the facilities installed by the host government (Tordo, 2009:2).

1.1.2 Tax regimes for the oil and gas industry

In terms of exploration and production of oil and gas resources, government and investors have the same goal. This goal is to maximize the value from the oil and gas resources. However, government and investors tend to disagree around the split of the value of the oil and gas resources (Tordo, 2009:11).¹ Two key issues that arise are how profits will be split between government and investors and how the costs involved in the exploration and production projects will be treated (Randon, 2011:62). Governments face the challenge of providing sufficient incentives to attract foreign investment while still collecting appropriate revenue from the extraction of the natural resource. An appropriately designed fiscal system could balance the objectives (United Nations Economic Commission for Africa, 2011:91). Table 1 provides a summary of the different objectives that government and investors have in terms of fiscal systems for the exploration and production of oil and gas resources.

¹ Supported by Baunsgaard, 2001:3

Table 1: Summary of objectives for a fiscal system

Government	Investor
<ul style="list-style-type: none"> - Supports macroeconomic stability by providing predictable and stable tax revenue flows - Captures a greater share of the revenue during periods of high profits - Maximizes the present value of revenue receipts by providing for appropriations during the early years of production - Is neutral and encourages economic efficiency 	<ul style="list-style-type: none"> - Has a minimum number of front-end-loaded non-profit-based taxes - Permits to repatriate profits to shareholders in their home countries - Is transparent, predictable, stable, and based on recognised industry standards

Source: Tordo 2009:11

There are two types of generic legal designs that are implemented in a variety of forms in the oil and gas industries around the world. These two types of designs are (Tordo, 2009:8):²

- (i) Concessions, which are also known as licenses and tax/royalty systems; and
- (ii) Contracts, which constitute production sharing contracts and service agreement contracts.

Concession systems:

Concession rights are granted to oil and gas companies which allow these companies to explore for and/or produce oil and gas within a specific area for a certain period of time. As a consequence of the concession right, the oil and gas company (investor) would assume all risks and costs associated with the exploration and production project. The Government will earn revenue, once the oil and gas is produced, from the use of the natural resource by the oil and gas company in the form of royalty and tax payments. In terms of the concession

² Supported by Baunsgaard, 2001:12

design the state has the liberty to modify the terms and conditions imposed by legislation. Government will try not to abuse their ability to modify the terms due to the desire to create a stable investment environment to attract investors and maintain investment. (Tordo, 2009:9)

The types of instruments through which government earns revenue in terms of the concession design include royalties, special petroleum taxes, property taxes and corporate taxes levied on income. The ownership of the oil or gas will remain with the state until the point where the oil or gas reaches the wellhead. Once the oil or gas has been produced and reaches the wellhead the ownership will pass to the oil and gas company (investor). The ownership of all the equipment and permanent fixtures used specifically for the exploration and production project will generally pass over to the government once the concession has expired or is terminated. (Tordo, 2009:9)

Production sharing contracts:

Developing nations find production sharing contracts very attractive as the government retain ownership of the reserves, but are able to share in the revenues from the oil and gas projects without any financial risk (Wood, 2008: 66)³

Production sharing contracts are part of a contract-based tax regime which contains an agreement between an oil and gas company (or more than one) and a state party. The production sharing contract can either grant general authority or an exclusive license to the oil and gas company to engage in oil and gas activities. (Tordo, 2009:10)⁴

Production sharing contracts, similar to the concession regime, will grant oil and gas companies the right to explore for oil and gas within a specific area and for a specific period of time. The oil and gas company will take on all exploration risks and costs in exchange for a share in the oil and gas which has been produced from the specific area stipulated in the production sharing agreement. The production is shared amongst the parties in terms of

³ Supported by World Bank, 2013: 3

⁴ Supported by Baunsgaard, 2001:12 and World Bank, 2013: 3

formulas which are stipulated in the relevant production sharing contract. As a result of the production sharing contract, the investor (the oil and gas company) will only receive ownership of its share of the production at the “export point”. This point would be defined in the production sharing contract. Any changes in the oil and gas price will result in adjustments to the production sharing formulas as stipulated in the production sharing contracts. The ownership of the equipment and permanent fixtures used specifically for the exploration and production project will generally pass over to the government upon commissioning. (Tordo, 2009:10)⁵

The mechanisms that determine the formulas of how production is shared (which are stipulated in the production sharing contracts) involve a distinctive element relating to profit and cost recovery. These elements are known as cost oil and profit oil. Cost oil is expressed as a fixed percentage of production revenue whereas profit oil is calculated as the remaining oil production after cost oil deductions. (Olivier & Futter, 2015:51)

The production sharing tax regime may also include royalties. In this case a royalty will be paid to the host government and the oil production that remains after this royalty is subsequently shared between cost oil and profit oil. In situations where there are unrecovered costs in a production sharing contract, the unrecovered costs may be carried forward to subsequent years. In some instances, the production sharing contract will allow for the costs to be uplifted to compensate for the delay in cost recovery. (Olivier & Futter, 2015:55)

In terms of production sharing contracts, a “signature bonus” is normally paid by the oil and gas company to the government on the date that the production sharing agreement is signed (Wood, 2008:66).

Service agreements:

In terms of a service agreement, government will hire a contractor to perform the exploration and production activities within a specific area and for a set period of time. These contractors

⁵ Supported by Baunsgaard, 2001:12 and World Bank 2013:3

can be compensated by either a fixed or variable fee. The contractor does not acquire any ownership to the oil and gas resources and the ownership of the resources remains with the government at all times, throughout exploration and production. (Tordo, 2009:10).

Summary of the different tax regimes:

Type	Concession	Production sharing contract (PSC)	Service agreement (SA)
Basic elements	In its most basic form, a concessionary system has three components: royalties, deductions (such as operating costs, depreciation, depletion and amortization), and taxes.	Under a PSC, the contractor receives a share of production for services performed. In its most basic form, a PSC has two components: cost recovery and the division of profit oil. However, many PSCs have four components: royalty, cost recovery, profit oil, and taxes.	Under a SA, the contractor receives a fixed or variable fee for the services performed. Corporate income taxes may apply.
Royalty	The royalty is normally a percentage of the proceeds of the sale of the hydrocarbon. It can be determined on a sliding scale, the terms of which may be negotiable or biddable or statutory, and paid in cash or in kind. The royalty is tax deductible.	Similar to concessionary systems. In addition, royalties are not normally cost recoverable but tax deductible.	Not applicable.

Fiscal costs	The definition of fiscal costs is described in the legislation of the country or in the particular concessionary agreement. Royalties and operating expenditures are normally expensed in the year in which they occur, and depreciation is calculated according to applicable legislation. Some countries allow the deduction of investment credits, interest on financing, and bonuses.	Fiscal costs are defined and rules for amortization and depreciation are established in the legislation of the country or in the particular PSC. After payment of royalties, the contractor is allowed to recover costs in accordance with contractual provisions (a cost recovery limit may apply). The remainder of the production is split between the host government and the oil company at a stipulated (often negotiated) rate.	Fiscal costs are defined and rules for amortization and depreciation are established in the agreement.
Cost recovery	There are no cost recovery limits.	Usually, costs can be recovered up to a limit as defined in the PSC.	Cost recovery limits are sometimes imposed on the contractor.
Taxable income	The taxable income under a concessionary agreement may be taxed at the country's basic corporate tax rate. Special investment incentive programs and special resource taxes may also apply. Tax losses may be carried forward until full recovery or for a limited period of time.	Corporate taxes may apply or may be paid by the host government or its national oil company on behalf of the contractor. Income tax is calculated on taxable income (revenue net of royalties, allowable costs, and government share of profit oil). Tax losses may be carried forward until full recovery or for a limited period of time.	Corporate taxes may apply or may be paid by the host government or national oil company on behalf of the contractor. Income tax is calculated on the difference between the service fees and the allowable costs. Tax losses may be carried forward until full recovery or for a limited period of time.

Source: Table from Tordo (2009:13)

1.1.3 The importance of foreign direct investment

Graham & Spaulding (2005:1) define foreign direct investment (“FDI”) as a company from one country physically investing into building a factory in another country. Over the years this classic definition has broadened to include the acquisition of an interest in a company incorporated in a foreign country. FDI can therefore take on many different forms (Graham & Spaulding, 2005:1). An alternative way of describing FDI is the investment made by multinational enterprises in foreign countries to control assets and production (Lodhi, Siddiqui & Habiba, 2013:1318). FDI has changed dramatically over time in terms of its size and scope. These changes were facilitated by modifications in technology, the liberalisation of the national regulatory framework governing investments and fluctuations in capital markets (Graham & Spaulding, 2005:1).

FDI is carried in high regard as most financial institutions, politicians and economists view it as a possible solution for economic problems. As a result of this common view, a number of different economic studies and literature reviews have been performed to determine the importance and the effect of FDI in a host country. According to economic theory, FDI has the potential to assist countries, who do not have sufficient domestic savings, to facilitate economic growth. The presence of a foreign company in the host country is associated with a number of positive externalities (Mengcinger, 2003:491).

Through a review performed by Gorg & Greenaway (2003:18), economic theory and empirical evidence showed that governments place an emphasis on attracting FDI. Government place this emphasis on attracting FDI as it is believed that foreign companies will not only boost national income with their investment, but that multinational enterprises bring superior technology and management to the host country. Furthermore, it is possible that the host country could enjoy the spill overs of superior technology and management as an external benefit to FDI. FDI is a therefore seen as a key driver in economic growth and development.

The oil and gas industry requires stable and long term investment and therefore FDI plays an important role in this industry. (Antolin & Cendrero, 2013:715). FDI is further desired in the oil and gas industry as exploration for oil and gas is a medium to long term exercise, one which

is extremely costly. (Futter, 2010:1). A common challenge in the African continent is a lack of skilled labour in the oil and gas sector (PWC, 2014:6). The use of FDI will result in international oil and gas companies providing the technical skilled labour and finance which is required in order to maintain, upgrade and develop facilities in the oil and gas sector (PWC, 2014: 38).

In Adrino's (2012:11) study on the effects of FDI on economic growth in South Africa, he found that South Africa as a developing country relies heavily on FDI for economic growth and that FDI is essential to ensure that South Africa's vast natural resources are managed and operated properly, which in turn would boost economic growth.

It is therefore important for government to attract and retain FDI as it is viewed as a key driver of economic growth as well as attracting superior technology, skilled labour and finances required in the oil and gas industry.

1.1.4 Methods of attracting foreign direct investment

By means of a literature study⁶ the main factors affecting FDI were identified as being market size, level of skilled labour, infrastructure, political stability, trade policies and natural resources. In addition to these main factors identified, another factor which would influence the location of FDI is the tax incentives provided by the host country. In their analysis of the effects of the use of tax incentives on foreign direct investment, the Organisation for Economic Co-operation and Development ("OECD") (2007:4), defines tax incentives as "the special exclusions, exemptions, deductions or credits that provide a preferential tax treatment or deferral of tax liability".

In a survey of tax incentives and FDI performed by the United Nations Conference on Trade and Development ("UNCTAD") (2000:11), it was confirmed that changing the primary factors influencing FDI (as listed above) can be difficult, time consuming or even outside of

⁶ Resources used for literature study include Adrino, M. 2012; Yasmin, B., Hussain, A. & Chaudhary, MA. 2003; Lodhi, RN., Siddiqui, MA. & Habiba, U. 2013; Adsiedu, E. 2006; Arvanitis, A. 2006

government control. However, government can more readily amend the tax incentives they offer. Governments would therefore prefer to provide tax incentives than correcting any deficiencies that could hinder foreign direct investment (OECD, 2007:5). In fact, to provide tax incentives as a method of attracting FDI has become a global phenomenon (Li, 2006:62).

According to Pouris (2003:195), tax incentives will make investments or projects more profitable as it will increase the after tax return of that investment or project. Exploration for oil and gas is extremely costly and it could take a while before investors receive any form of return on their investments as exploration is a medium to long term project. Governments have therefore recognised that they need to make it more attractive for global companies to invest. (Olivier & Futter, 2015:38)

Due to the length of the projects and the costs involved in exploration for oil and gas, investors require a stable investment environment. Investors have also indicated that, in making the decision to invest in a host country, transparency, stability, simplicity and certainty in the application of the tax law and in tax administration are more important to them than the actual special tax incentives (OECD, 2007:4). Therefore, tax incentives that are difficult to understand or apply, non-transparent tax regimes that often change or that are difficult to administrate, are discouraging to foreign investors (OECD, 2007:5). In their review of the oil and gas sector, PWC (2014:45)⁷ confirms that no matter how attractive a country's oil and gas possibilities are, should there be uncertainties with tax regulations in the host country, they will have great difficulty to remain attractive to the foreign investors.

Therefore, when government makes use of tax incentives as a method to attract FDI, it is important for the government to ensure that it creates a stable investment environment. The incentives would therefore need to be transparent, create stability, be simple to understand and provide certainty.

Olivier & Futter (2015:39) confirm that countries with less favourable geological conditions (i.e. oil and gas possibilities) will normally offer more attractive fiscal terms. However, when

⁷ Supported by Laporte & De Quatrebarbes, 2015:9

tax incentives are used as a method of attracting FDI, governments need to keep in mind that crude oil and natural gas are valuable assets that are non-renewable. The tax and revenue generation by government is viewed as an important benefit from the development of the oil and gas sector. As a resource owner, it is the responsibility of government to ensure that the fiscal regime is appropriately designed in order to receive the appropriate share of the economic rent generated from extraction of its oil and gas resource (Sunley et al, 2002:1) and that the tax incentives used do not erode the tax base completely (Moolman, 2012:27).

As it is evident that countries are in competition for investment, governments could lower the investor's tax liability to such an extent that the country is worse off than before the successful attraction of investment. (Moolman, 2012:26). However, if the appropriate capital is not attracted and as a result the oil and gas resource is not utilized it will result in unearned revenue and it will not benefit the government or investors (Moolman, 2012:27). It is therefore necessary that a balance between risk and reward, for both government and the investor, is found (Moolman, 2012:26).

Taxation plays a major role in financing development and often developing countries are not able to raise the tax revenue required for development due to over-generous tax incentives which have not been critically analysed (ActionAid, 2014:1). When revenue is lost as a result of tax incentives, the tax burden is often pushed on to individuals and households through an increase in indirect taxes. This increase in indirect taxes will have a negative effect on people in living in poverty and low income earners which will be expected to pay increased taxes (ActionAid, 2014: vi).

It can thus be seen from the above that in order to attract FDI a country needs to be competitive with other countries in terms of what it can offer the foreign company looking to invest, but at the same time ensure that what it is offering the foreign companies, is fiscally responsible (Parcano, 1993:2). Furthermore it is important for the government to ensure that it creates a stable investment environment.

1.1.5 Oil and gas in South Africa

Until the recent discoveries of possible shale gas reserves in the Karoo basin, South Africa's potential oil and gas reserves were considered insignificant relative to the country's other non-renewable resources (Havemann, 2014:1). With limited proven oil and gas reserves, South Africa relies heavily on its energy-intensive coal mining industry to meet the majority of its energy needs (Petroleum Agency SA, 2015). In recent years there has been an increase in interest in South Africa's offshore oil and gas potential (Petroleum Agency SA, 2015) and in the last three years nearly all of the South African offshore acreage has been licensed. It is submitted that substantial offshore exploration is expected in South African waters within the next few years. South Africa's oil and gas reserves may soon reach a stage where it can no longer be labelled as insignificant (Havemann, 2014:2).

The South African Legislation on oil and gas companies is regulated by the Mineral and Petroleum Resources Development Act 28 of 2002 ("MPRDA") while the tax regime governing the South African oil and gas industry is a concession system. Oil and Gas companies are subject to the ordinary tax rules within the Income Tax Act 58 of 1962 ("the Act"), but enjoy certain tax concessions within the Tenth Schedule to the Act. The Tenth Schedule to the Act aims to incentivise investment in South Africa. The Explanatory Memorandum on the Revenue Laws Amendment Bill (2006: 15) explains that the main reason for introducing the Tenth Schedule was to create certainty and transparency for oil and gas exploration and production with the aim to secure investment.

In the preceding 10 years there has been extreme volatility in oil and gas prices around the world, which put pressure on government to increase their share in the revenues from the extraction of oil and gas. A more volatile investment climate was created in the oil and gas industry due to constant government action to increase their share in revenues (Olivier & Futter, 2015:35). The Tenth Schedule provides that, should there be a change in the price of oil, investors will not be subject to increased corporate taxes. This provision allows for increased stability which is attractive in large scale, high risk oil and gas projects. (Olivier & Futter, 2015:36)

1.2 Research Question

Foreign investment is generally anticipated to generate a number of economic benefits in the receiving jurisdiction. Considering the growth potential of South Africa's oil and gas industry and the long term investment required from large multinational corporations, the Tenth Schedule was introduced to create certainty and transparency in the hopes of securing such investment. The research question that follows is: Does the Tenth Schedule to the Income Tax Act achieve its aim of providing certainty and transparency in order to attract and retain foreign investment in the oil and gas industry? Furthermore, what issues and uncertainties can be found in the Tenth Schedule which could hinder such foreign investment? Finally, as countries are in competition with one another to attract foreign investment, how do the incentives provided by the Tenth Schedule compare to the incentives provided by Ghana's oil and gas tax regime.

1.3 Research Method

The research methods adopted for this dissertation is qualitative in nature and typical of doctrinal research. This type of research method is described by McKerchar (2008:1) as the systematic process of identifying, analysing, organising and synthesising statutes, judicial decisions and commentary.

1.4 Scope of Dissertation

The scope of this dissertation is limited to the corporate income tax implications of exploration and post-exploration of oil and gas companies under the MPRDA and the Income Tax Act.

This dissertation does not consider the taxation of midstream and downstream oil and gas activities. The following tax types are also not addressed in the dissertation: Employees' tax, Value Added Tax, International Tax and state royalties. Furthermore this dissertation does not deal with international tax considerations such as place of effective management, Transfer Pricing, Thin Capitalisation, Controlled Foreign Corporations and Double Taxation Agreements, including the definition of Permanent Establishment.

Only items of revenue and expenditure that are directly associated with oil and gas exploration and post-exploration, as dealt with in the Tenth Schedule, have been considered. The consideration of revenue and expenditure is limited to the corporate income tax legislation of such items for the year of assessment ending 2015/2016.

In considering how the tax incentives provided by the Tenth Schedule to the Act compared to the tax incentives provided by other jurisdictions, Ghana was considered to be an acceptable country for comparison for the following reasons:

- South Africa and Ghana are both developing countries in Africa which wish to attract foreign direct investment by providing tax incentives.
- Neither South Africa nor Ghana received favourable rankings in respect of the proved oil reserves list and proved natural gas reserves list according to the Central Intelligence Agency (“CIA”) World Factbook (2015). However, there has been an increase in South Africa’s oil and gas potential and in the last few years nearly all of South Africa’s offshore acreage has been licensed (Petroleum Agency SA, 2015). The first commercial oil find in Ghana was in 2007 which was followed by the commencement of commercial production, in the so called Jubilee-field in 2010. There has been significant discoveries in the Jubilee field, as well as other offshore oil and gas discoveries in Ghana (Allotey, 2011: 1). Therefore, both South Africa and Ghana have the potential to be seen as major oil and gas producing countries in the next few years.
- Ghana has a concession tax regime similar to that of South Africa.

A detailed explanation for each of these reasons can be found in Chapter 4.

1.5 Dissertation outline

Following this introduction chapter, chapter 2 provides an overview of the incentives provided by the Tenth Schedule in the aim to attract and secure foreign investment. Chapter 3 identifies

those issues and uncertainties within the provisions of the Tenth Schedule that could hinder foreign direct investment and considers whether the Tenth Schedule has achieved its aim of providing certainty and transparency in the aim to secure foreign direct investment. Chapter 4 provides an overview of the Ghana oil and gas tax regime and Chapter 5 investigates how the incentives provided by the Tenth Schedule compare to the incentives provided by the Ghana oil and gas tax regime. Chapter 6 summarises the conclusions raised in the preceding chapters and provides an overall conclusion to the above research questions raised.

2. CHAPTER 2 – THE TAX INCENTIVES PROVIDED BY THE TENTH SCHEDULE IN ORDER TO ATTRACT FDI

2.1 Introduction

It was highlighted in Chapter 1 that the oil and gas industry requires stable and long term investment. Chapter 1 explained how exploration for oil and gas is an extremely costly medium to long term exercise and thus FDI is a prerequisite for the development of the oil and gas industry. The use of FDI will result in international oil and gas companies providing the technical skilled labour and finance which is required in order to maintain, upgrade and develop facilities in the oil and gas sector (PWC, 2014: 38).

A popular method used by government to attract foreign investment is to provide tax incentives. Government find it more attractive to provide tax incentives⁸ as opposed to correcting any deficiencies that could hinder foreign investment as tax incentives do not require actual expenditure or cash and from a political point of view they are easier to provide (OECD, 2007:5).

Investors require a stable investment environment due to the length of the projects and the costs involved in exploration for oil and gas. Investors have also indicated that, in making the decision to invest in a host country, it is important to have transparency, stability, simplicity and certainty in the application of the tax law and in tax administration as opposed to special tax incentives (OECD, 2007:4)⁹. Tax incentives that are difficult to understand or apply are discouraging to foreign investors. Tax regimes that are non-transparent, ever changing or are difficult to administrate are other discouraging features to foreign investors (OECD, 2007:5). In a review performed by PWC (2014:45) of the oil and gas sector, PWC (2014:45) emphasises that no matter how attractive a country's oil and gas possibilities are, should there be uncertainties with tax regulations in the host country, they will have great difficulty to remain attractive to the foreign investors.¹⁰

⁸ The OECD (2007:4) defines tax incentives as "the special exclusions, exemptions, deductions or credits that provide a preferential tax treatment or deferral of tax liability"

⁹ Supported by World Bank, 2013: 29

¹⁰ Supported by Laporte & De Quatrebarbes, 2015:10

Therefore, when government makes use of tax incentives as a method to attract FDI, it is important for the government to ensure that it creates a stable investment environment. The incentives should therefore have the following features: create stability, be simple to understand and provide certainty.

When tax incentives are used as a method of attracting FDI, governments need to keep in mind that crude oil and natural gas are valuable assets that are non-renewable. The most important benefit from the development of the oil and gas sector is the tax and other revenues generated by government. As a resource owner, it is the responsibility of government to ensure that the fiscal regime is appropriately designed in order to receive the appropriate share of the economic rent generated from extraction of its oil and gas resource (Sunley et al, 2002:1) and that the tax incentives used do not erode the tax base completely (Moolman, 2012:27).

The legal framework in the South African for oil and gas companies is regulated by the MPRDA while the tax regime governing the South African oil and gas industry is a concession system.¹¹ Oil and Gas companies are subject to the ordinary tax rules within the Act, but enjoy certain tax concession within the Tenth Schedule to the Act. The Tenth Schedule to the Act aims to incentivise investment in South Africa. The Tenth Schedule tax regime was formulated, and brought into use, in November 2006 to replace the previous investment regime for oil and gas companies which was established in terms of the OP26 prospecting lease agreements. It was around June 2007 that the OP26 regime was expected to terminate and uncertainty arose around the renewal of the fiscal provisions that were contained in the OP26 regime. The uncertainty led to a number of companies postponing their investment in the South African oil and gas environment until such a time as the uncertainty was resolved (National Treasury, 2006:15). The above reiterates the importance of certainty in a tax regime for investors. The Explanatory Memorandum on the Revenue Laws Amendment Bill (2006: 15) explains that the main reason for introducing the Tenth Schedule was to create certainty and transparency for oil and gas exploration and production in the aim to secure investment.

¹¹ See Chapter 1 for a detailed explanation of the concession system

This Chapter will provide an overview of the incentives provided by the Tenth Schedule and will aim to review these incentives in order to determine whether the design of the Tenth Schedule to the Act could achieve the aim of attracting and retaining FDI through certainty and transparency.

2.2 Incentives provided by the Tenth Schedule

The Tenth Schedule has a limited application to oil and gas companies. An oil and gas company is defined as any company which holds an oil and gas right or which engages in exploration or post exploration in terms of any oil and gas right.

Exploration and post-exploration are defined as:¹²

“exploration’ means the acquisition, processing and analysis of geological and geophysical data or the undertaking of activities in verifying the presence or absence of hydrocarbons (up to and including the appraisal phase) conducted for the purpose of determining whether a reservoir is economically feasible to develop”

“post-exploration’ means any activity carried out after the completion of the appraisal phase, including (a) the separation of oil and gas condensates; (b) the drying of gas; and (c) the removal of non-hydrocarbon constituents, to the extent that these processes are preliminary to refining”

The provisions of the Tenth Schedule regulate the taxation of income derived from oil and gas operations by oil and gas companies. The income derived from oil and gas operations is defined as receipts and accruals derived from exploration and post-exploration in respect of any oil and gas right or the leasing or disposal of any oil and gas right. Income which is not derived from oil and gas activities will be subject to the ordinary tax rules in South Africa.

¹² Defined in the Tenth Schedule to the Act.

In terms of paragraph 6 of the Tenth Schedule, a company that holds an oil and gas right is deemed to be carrying on a trade in respect of that oil and gas right and therefore any expenditure or losses incurred by the company in respect of the oil and gas right are deemed to be incurred in the production of income of the company. This provision is to ensure that oil and gas companies will qualify for tax deductions under the normal South African tax rules and that losses do not lapse in situations where there is a temporary suspension of the business.¹³

The Tenth Schedule provides a number of attractive incentives such as the exemption from dividends withholding tax and withholding tax on interest, permissible super-deductions, the roll forward of assessed losses, rollover treatment and participation treatment in respect of the disposal of oil and gas assets and fiscal stability agreements.

2.2.1 Tax Rate

A possible tax incentive that Government could implement is a lower income tax rate, however the income tax rate under the Tenth Schedule is capped at the current corporate tax rate.¹⁴ This rate is applicable to all companies in South Africa. It appears therefore, that the tax rate levied on oil and gas companies in South Africa is not used as a tax incentive to attract FDI (Futter, 2010: 20).

In Moolman's (2012:45) comparison of the tax incentives provided in South Africa to that of China, India and the United States of America, she found that South Africa's corporate income tax rate compared favourably to the corporate tax rate of these oil and gas importing countries and may therefore still be attractive to investors.

¹³ Section 11 of the Act provides that a company should be carrying on a trade in order to deduct any qualifying expenses. In the same way, Section 20 of the Act only allows for the set off of assessed losses of a company which is carrying on a trade.

¹⁴ The current corporate tax rate in South Africa is 28%.

2.2.2 Withholding taxes

Currently the Act provides for dividends withholding tax and withholding tax on interest to be withheld from payments made to foreign persons. As a form of incentive, the Tenth Schedule provides relief for oil and gas companies from these withholding taxes.

Paragraph 3 of the Tenth Schedule provides that any dividends distributed from the income of an oil and gas company will be subject to a dividends withholding tax at a rate of zero percent. In the case of dividends being paid out of refining income or other income, other than oil and gas income as defined,¹⁵ the normal withholding tax rate under section 64E of the Act of 15% will apply (subject to the standard exemptions or relief in certain circumstances).

An amount of interest paid to a foreigner would be subject to withholding tax of 15% under the provisions of section 50B. Paragraph 3, however, limits the withholding tax applicable to any cross-border interest in respect of loans, which were applied to fund expenditure of a capital nature in respect of exploration and post-exploration, to zero.

2.2.3 Allowable deductions and super-deductions

As a form of incentive, paragraph 5 of the Tenth Schedule provides that in determining the taxable income of an oil and gas company there shall be allowed as a deduction from the oil and gas income of such a company, all expenditure actually incurred in respect of exploration and post-exploration (i.e. operating expenditure and expenditure of a capital nature). The cost to acquire an oil and gas right is, however, not allowed as a deduction.

In addition to the above, paragraph 5 provides for an additional 100% deduction for expenditure of a capital nature which is incurred in respect of exploration as well as an

¹⁵ Oil and gas income is defined as receipts and accruals derived from exploration and post-exploration in respect of any oil and gas right or the leasing or disposal of any oil and gas right.

additional 50% deduction for expenditure of a capital nature which is incurred in respect of post-exploration. Therefore, under the provisions of the Tenth Schedule, an oil and gas company would essentially benefit from a 200% super-deduction of exploration expenditure of a capital nature and a 150% super-deduction of post-exploration expenditure of a capital nature.

The super-deductions act as incentives to invest in high-risk and high cost capital expenditure. Exploration is higher in risk due to the costly searches for oil and gas possibly being unsuccessful and therefore enjoys a higher uplift or benefit (National Treasury, 2006:19).

Investors would generate taxable oil and gas income¹⁶ from exploration and post-exploration activities and these super-deductions would reduce this taxable income. This would in turn increase the after tax return of investors. In the event that the super-deductions result in assessed losses, these losses are allowed to be carried forward to the following years of assessment.¹⁷

2.2.4 Assessed losses

Paragraph 5 of the Tenth Schedule provides that assessed losses incurred by an oil and gas company, in respect of exploration and post-exploration, may be set off against oil and gas income as defined¹⁸ as well as income from the refining of gas which was derived in respect of an oil and gas right held by the company. Furthermore, if any amount remains after the offsetting of the assessed loss against such income, 10% of the remaining assessed loss may be set off against other income (i.e. income other than oil and gas income). If any loss remains after the 10% set-off, the loss may be carried forward to the following year of assessment.

¹⁶ Oil and gas income is defined as receipts and accruals derived from exploration and post-exploration in respect of any oil and gas right or the leasing or disposal of any oil and gas right.

¹⁷ See 2.4.4 for a detailed discussion of assessed losses.

¹⁸ Oil and gas income is defined as receipts and accruals derived from exploration and post-exploration in respect of any oil and gas right or the leasing or disposal of any oil and gas right.

The purpose of allowing the oil and gas assessed loss to be set off against other income is to provide relief for ordinary working capital (National Treasury, 2006:19). Although oil and gas companies would engage in some peripheral activities that would not necessarily be part of oil and gas income, it can be seen that this would encourage oil and gas companies to engage in further activities (other than oil and gas activities), in order to utilize the offsetting of the oil and gas assessed loss (up to 10%) and therefore generate tax revenue for government from these non-related activities (Moolman, 2012:50).

2.2.5 Disposal of oil and gas right

In South Africa, oil and gas companies will be taxed in terms of the provisions of the Act, subject to the provisions contained in the Tenth Schedule. In practice, when an activity or transaction is covered explicitly by the Tenth Schedule, the Tenth Schedule will apply. However, if the activity or transaction is not covered by the Tenth Schedule, the ordinary provisions of the Act will apply.

Paragraph 7 of the Tenth Schedule provides that when an oil and gas company (seller) disposes of an oil and gas right to another company (acquirer), the seller and the acquirer may agree to apply either the “rollover treatment” or the “participation treatment” to the sale transaction. In the event that either one of the above two treatments are selected, the provisions of the Tenth Schedule will apply. If neither previously mentioned treatments are selected, the disposal will be taxed under the ordinary rules of the Act, which include the capital gains tax provisions contained in the Eighth Schedule to the Act.

Rollover treatment or participation treatment may apply when the market value of the right being disposed of exceeds its base cost¹⁹ (in the case where the right was held as a capital asset) or its tax cost²⁰ (in the case where the right was held as trading stock)

¹⁹ The base cost as determined by paragraph 20 of the Eighth Schedule to the Act.

²⁰ The tax cost as determined by section 22 of the Act.

In terms of the rollover treatment, the selling company is deemed to have sold the oil and gas right for an amount equal to its base cost or tax cost. Therefore, when the rollover treatment is selected, any gain for the selling company is eliminated and the acquiring company is deemed to acquire the right at its base cost or tax cost.

In terms of the participation treatment, the selling company treats all gains made under the sale transaction as gross income revenue, regardless of whether the oil and gas right was held as a capital asset or as trading stock. The acquiring company is allowed to deduct from its oil and gas income an amount equal to the amount included in the gross income of the selling company. Therefore, the effect of participation treatment is that any loss from oil and gas income in the selling company would be transferred from the seller to the acquirer. Participation treatment will most likely be chosen when the seller has an assessed loss, as the seller can utilise the assessed loss and the acquirer can deduct the capital expense immediately (Moolman, 2012:53).

The rollover treatment and the participation treatment are attractive incentives as these provisions allow the investor to eliminate any gain from the sale of an oil and gas asset or to transfer an assessed loss to the purchaser of the oil and gas asset.

2.2.6 Fiscal Stability Agreements

As set out in the introduction to this chapter, government will use incentives to attract international oil companies to obtain the capital, expertise and management required for successful projects in the oil and gas industry. Once the international oil companies have made their investment, they are however at the mercy of the host government. Therefore, in their quest for stability and predictability in their return on investment, investors seek to fix fiscal provisions. (Deloitte, 2014:3). Olivier & Futter (2015:77) confirms that “*fiscal stability is essential to secure investor confidence in the oil and gas environment where the capital outline is significant and the geological uncertainty is pervasive.*”

Oil and gas investment consists of high initial sunken capital costs with high risk of unsuccessful exploration and delayed profit in the case of successful finds. It is therefore important to have a fiscal stability clause which can facilitate future oil and gas investment (National Treasury, 2006:23).

Paragraph 8 of the Tenth Schedule provides that the Minister of Finance may enter into a fiscal stability agreement with an oil and gas company in respect of an oil and gas right held by that company. This fiscal stability agreement will guarantee that the provisions of the Tenth Schedule, as at the time that the fiscal stability agreement was entered into, will apply for the duration of the period that the oil and gas right is held by the company.

The Minister of Finance may also enter into a fiscal stability agreement with a company in anticipation of an oil and gas right to be acquired by that company, provided that the oil and gas right is granted within one year after the agreement is concluded. The fiscal stability agreement will apply from the date that the oil and gas right is granted.

Upon the disposal of an exploration or production right, fiscal stability rights may be assigned to another oil and gas company. In the case of an exploration right, the fiscal stability rights may be assigned to any other oil and gas company, however in the case of a disposal of a production right, the fiscal stability rights may only be assigned to a company that forms part of the same group of companies as the company disposing of the production right at the time the fiscal stability agreement was concluded.

If an oil and gas company jointly hold an oil and gas right with another company and any one of those companies have entered into a fiscal stability agreement, the rights in respect of the agreement will apply to both companies. Should an oil and gas company holding a participating interest in an oil and gas right, conclude a fiscal stability agreement, the terms of that agreement will apply to all participating interests subsequently held by that company in that oil and gas right.

In addition to the fiscal stability agreements provided for by the Tenth Schedule, the Mineral and Petroleum Resources Royalty Act of 2008 (“Royalty Act”) provides that oil and gas companies may also enter into royalty fiscal stability agreements in respect of the royalties levied by the Royalty Act.

2.2.7 Conclusion

From the above review the Tenth Schedule provides attractive and generous tax incentives. Furthermore, the provisions, the different conditions for application of the provisions and the applicable definitions contained within the provisions of the Tenth Schedule are set out clearly.

For example, the withholding tax incentive for reduced rates of dividends withholding tax and withholding tax on interest is only applicable to dividends and interest in respect of defined income and funding for oil and gas companies. The provisions in paragraph 7 clearly set out the different criteria and applications of the rollover treatment and participation treatment. The fiscal stability provisions are set out clearly and the assessed loss provision contained in paragraph 5 clearly defines the types of losses that may be set off against specific types of income.

2.3 Chapter conclusion

The Tenth Schedule to the Act was brought into effect with the main objective of creating certainty and transparency for oil and gas exploration and production in the hope of securing investment. This Schedule is relatively new and a number of amendments have been introduced over the years to ensure that the Schedule achieves its aim of providing oil and gas companies with attractive incentives and benefits (Scholtz, 2015:1).

The Tenth Schedule contains a number of very attractive incentives which would defer the payment of tax for a number of years. These incentives include an exemption from dividend withholding tax and withholding tax on interest, super-deductions, the roll forward of assessed losses, rollover treatment and participation treatment in respect of the disposal of oil and gas assets, and fiscal stability agreements.

The incentives would competitively increase the after-tax return for investors in the oil and gas industry compared to investors in other industries in South Africa. As investors would be aware of the income tax consequences of their investment, they will be able to plan their financial strategies in advance (Moolman, 2012:58).

From the above review of the incentives provided by the Tenth Schedule, the incentives are generally clear, transparent and fiscal stability agreements provide the necessary stability.

However, in order to determine whether the design of the Tenth Schedule to the Act actually achieves its aim of attracting and retaining FDI through certainty and transparency, it is necessary to establish whether there are any issues or uncertainties contained within the Tenth Schedule that would create uncertainty or instability to such an extent that it would substantially hinder foreign direct investment.

Chapter 3 will evaluate the issues and uncertainties raised by the International Monetary Fund, the Oil and Gas Sub-Committee to the Davis Tax Committee and stakeholders in the oil and gas industry and will determine whether these issues and uncertainties could hinder FDI.

3. CHAPTER 3 – EVALUATION OF ISSUES OR UNCERTAINTIES CONTAINED WITHIN THE TENTH SCHEDULE

3.1 Introduction

In previous chapters it was highlighted that FDI is a prerequisite for the oil and gas industry as exploration for oil and gas is a medium to long term exercise. One of the methods used by governments in order to attract the necessary FDI is to provide tax incentives.

The Explanatory Memorandum on the Revenue Laws Amendment Bill (2006: 15) explains that the main reason for introducing the Tenth Schedule was to create certainty and transparency for oil and gas exploration and production in the aim to secure investment.

Chapter 2 concluded that the Tenth Schedule contains a number of very attractive incentives which would defer the payment of tax for a number of years. It was concluded that the incentives are generally clear, transparent and fiscal stability agreements provide the necessary stability.

However, in order to determine whether the Tenth Schedule to the Act actually achieves its aim of attracting and retaining FDI through certainty and transparency, it is necessary to establish whether there are any issues or uncertainties contained within the Tenth Schedule that would create uncertainty or instability to such an extent that it would substantially hinder foreign direct investment.

In order to do so, a review was done of the issues and uncertainties raised by the International Monetary Fund, the Oil and Gas Sub-Committee to the Davis Tax Committee and stakeholders in the oil and gas industry.

3.2 Issues or uncertainties identified

3.2.1 Withholding tax on services

The Act currently provides for dividends withholding tax and withholding tax on interest to be withheld from payments made to foreign persons. As a form of incentive, the Tenth Schedule provides relief for oil and gas companies from these withholding taxes. This is explained in more detail in Chapter 2 under point 2.2.2.

There is a new proposed withholding tax on service fees paid to foreign persons for which paragraph 3 does not provide any relief.

The proposed section 51B (1) of the Act provides that:

“There must be levied for the benefit of the National Revenue Fund a tax, to be known as the withholding tax on service fees, calculated at the rate of 15 per cent of the amount of any service fee that is paid by any person to or for the benefit of any foreign person to the extent that the amount is regarded as having been received by or accrued to that foreign person from a source within the Republic.”

This section is proposed to come into effect on 1 January 2017 and will be applicable to service fees paid or that become due and payable on or after that date.

Section 51A of the Act defines service fees as:

“any amount that is received or accrues in respect of technical services, managerial services and consultancy services but does not include services incidental to the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of such knowledge or information.”

The current position is that the Tenth Schedule does not provide for an exemption from the new proposed withholding tax on service fees. This is inconsistent with the incentives provided by paragraph 3.

3.2.2 Allowable deductions and super-deductions

Under the provisions of paragraph 5 of the Tenth Schedule, an oil and gas company would benefit from a 200% super-deduction of exploration expenditure of a capital nature and a 150% super-deduction of post-exploration expenditure of a capital nature. This is explained in more detail in Chapter 2 under point 2.2.3.

The Tenth Schedule defines exploration and post-exploration as:

“exploration’ means the acquisition, processing and analysis of geological and geophysical data or the undertaking of activities in verifying the presence or absence of hydrocarbons (up to and including the appraisal phase) conducted for the purpose of determining whether a reservoir is economically feasible to develop”

“post-exploration’ means any activity carried out after the completion of the appraisal phase, including (a) the separation of oil and gas condensates; (b) the drying of gas; and (c) the removal of non-hydrocarbon constituents, to the extent that these processes are preliminary to refining”

It can be seen from the above definitions that exploration and post-exploration is not defined with reference to whether an exploration or production right is held by the company. The definition above makes reference to the activities performed by the company. For purposes of applying the super-deductions, the above definition may therefore make it difficult to determine whether an activity is actually exploration or post-exploration. From a tax liability perspective it would be more beneficial to classify expenditure of a capital nature as exploration expenditure to take advantage of such super-deduction and companies would therefore wish to hold an exploration right for as long as possible in order to support this argument. (Daniel et al, 2015:15).

Furthermore, it is also important to establish whether the exploration or post-exploration expenditure incurred by an oil and gas company is actually of a capital nature. The term “of a capital nature” is however not defined in the Act and depends on a complex body of case law. (Daniel et al, 2015:15).

Some of the principles established through our case law include:

“The legal categorization of the expenditure does not determine whether it is of a revenue or a capital nature. ‘The true nature of each transaction must be enquired in order to determine whether the expenditure attached to it is capital or revenue expenditure’. (CSARS v BP South Africa (Pty) Ltd 2006 SCA)”

“Expenditure incurred as part of the cost of performing the income-earning operations of the company is revenue in nature whereas expenditure incurred as part of the cost of establishing or improving or adding to the income-earning plant or machinery, or the income producing structure of the business of the business is capital in nature. (New State Areas Ltd v CIR 1946 AD; SIR v Cadac Engineering Works (Pty) Ltd 1965 AD))”

“Expenditure incurred with a purpose of bringing into existence an asset or an advantage for the enduring benefit of a trade is ordinarily capital in nature. (New State Areas Ltd v CIR 1946 AD)”

An argument may be made that recurrent expenditure (like salaries, rentals and interest²¹) incurred by an oil and gas company is capital in nature being expenditure incurred to bring into existence an asset or advantage for the enduring benefit of trade. However, this argument may be weak and could be challenged by the revenue authorities. It is also not clear whether the intention of paragraph 5 is to provide the benefit of super-deductions to expenditure like salaries, rentals, and interest (Scholtz, 2015:1).

²¹ Salaries, rentals and interest would normally be revenue in nature as it would form part of the cost of performing income-earning operation of a company.

The above uncertainties in respect of exploration vs non-exploration expenditure and expenditure of a capital nature versus expenditure of a revenue nature may cause some difficulty in the application of the super-deductions.

3.2.3 Disposal of oil and gas right

Paragraph 7 of the Tenth Schedule provides that when an oil and gas company (seller) disposes of an oil and gas right to another company (acquirer), the seller and the acquirer may agree to apply either the “rollover treatment” or the “participation treatment” to the sale transaction. Essentially rollover treatment and the participation treatment will allow the investor to eliminate any gain from the sale of an oil and gas asset or to transfer an assessed loss to the purchaser of the oil and gas asset. The rollover treatment and participation treatment is explained in more detail in Chapter 2 under 2.2.5.

In the event that the rollover treatment or the participation treatment is not selected, the provisions of the Act, which include the capital gains provision contained in the Eighth Schedule, will apply. Thus a capital gain will arise to the extent that the proceeds²² received exceed the base cost²³ of the asset. The Eighth Schedule provides that only 66.67% of the capital gain arising from the disposal will be included in taxable income.

However, there is some uncertainty with regards to the inclusion rate for the oil and gas industry as the Tenth Schedule includes receipts and accruals derived from the disposal of an oil and gas right in the definition of oil and gas income.²⁴ This potentially conflicts with the inclusion rate for capital gains as per the Eighth Schedule. Therefore, in the event that the rollover treatment or participation treatment is not selected, it is not clear whether the full disposal proceeds will be included in taxable income (in terms of the definition of oil and gas

²² Proceeds from the disposal of an asset by a person are equal to the amount received by or accrued to that person in respect of the disposal.

²³ The base cost as determined by paragraph 20 of the Eighth Schedule to the Act.

²⁴ Oil and gas income is defined as receipts and accruals derived from exploration and post-exploration in respect of any oil and gas right or the leasing or disposal of any oil and gas right.

income as per the Tenth Schedule) or only a 66.67% of the capital gain arising from disposal (as per the provisions of the Eighth Schedule).

3.2.4 Fiscal Stability Agreements

Paragraph 8 of the Tenth Schedule provides that the Minister of Finance may enter into a fiscal stability agreement with an oil and gas company in respect of an oil and gas right held by that company. This fiscal stability agreement will guarantee that the provisions of the Tenth Schedule, as at the time that the fiscal stability agreement was entered into, will apply for the duration of the period that the oil and gas right is held by the company. More detail regarding the fiscal stability agreements is provided in Chapter 2 under point 2.2.6.

The fiscal stability provisions are set out clearly and provide certainty and stability. However, some of the shortcomings identified within the Tenth Schedule in relation to fiscal stability agreements include (Futter, 2010:57):

- i) the fiscal stability agreements will not cover all taxes that could be levied on an oil and gas company (i.e. it only covers income tax provisions)
- ii) fiscal stability agreements do not prevent the introduction of new taxes to oil and gas companies
- iii) upon disposal of a production right, the fiscal stability rights may only be assigned to a company that forms part of the same group of companies as the company disposing of the production right at the time the fiscal stability agreement was concluded. Therefore, once an oil and gas company has entered into production, fiscal stability agreements cannot be transferred to third parties and can only be transferred to group companies.

As fiscal stability agreements cannot be transferred to third parties once a company has entered production, Olivier & Futter (2015:58) is of the opinion that a new investor or oil and gas company would not enter the South African oil and gas industry on the same level playing field to existing participants, which might discourage new entrants. This might be true, however each investor would have different risk profiles in terms of exploration and post-

exploration and it may therefore be more beneficial for the new investors to enter into a stability agreement that is unique to their project (to the extent that the terms are negotiable).

3.2.5 Recoupment of expenditure

Daniel et al. (2015:17), in their report to the Davis Tax Committee, point out that the 200% and 150% super deductions are deducted once off in the year of assessment in which the qualifying capital expenditure is incurred. It appears as though the Tenth Schedule does not provide for any recoupment of the deductions if expenditure of a capital nature is redeemed. They explain that: “...*proceeds on disposal of an asset that qualified for the deduction is not increased by a similar percentage. There could be an incentive to sell an asset into a petroleum company and buy it back shortly after for a very significant tax advantage (subject to the general anti-abuse rules)*”. This view is supported by Olivier & Futter (2015:73) in their report from the oil and gas sub-committee to the Davis Tax Committee.

In practice, when an activity or transaction is covered explicitly by the Tenth Schedule, the Tenth Schedule will apply. However, if the activity or transaction is not covered by the Tenth Schedule, the ordinary provisions of the Act will apply. Section 8(4) of the Act provides that there shall be included in the taxpayer’s income all amounts allowed to be deducted under (amongst others) section 11 to 20, whether in the current or any previous year of assessment which have been recovered or recouped during the current year of assessment. Section 11(x) includes any deductions in terms of other provisions of the Act. Therefore, if any deductions in terms of other provisions of the Act were recovered or recouped during the year such amounts would be included in the taxpayer’s income in terms of Section 8(4) through the deductions allowed in section 11(x).

One could therefore argue that as section 26B²⁵ provides for the manner in which an oil and gas company’s taxable income should be calculated with reference to the Tenth Schedule,

²⁵ Section 26B of the Act provides that “*the taxable income of any oil and gas company, as defined in the Tenth Schedule, shall be determined in accordance with the provisions of this Act but subject to the provisions of that Schedule*”.

section 26B provides for the specific deductions allowed under the Tenth Schedule and these deductions would therefore fall under section 11(x) (being deduction allowed in terms of other provisions of the Act) and ultimately be recouped under section 8(4).

However, in the end it is not clear whether there is any recoupment of the super-deductions should the capital expenditure previously deducted be recovered as the Tenth Schedule does not specifically provide for this recoupment. It is also not clear whether the Tenth Schedule intentionally does not provide for any recoupment as part of the generous incentives provided in order to attract foreign direct investment.

3.2.6 Rehabilitation expenditure

Section 37A of the Act provides that any expenditure paid by an oil and gas company to a rehabilitation company or trust, i.e. a company or trust whose sole objective is to apply its property for rehabilitation of environmental impacts, will be deductible from the oil and gas company's taxable income.

There is some uncertainty regarding the application and interaction of section 37A of the Act and the Tenth Schedule. Section 37A could apply to oil and gas activities, but section 26B gives priority to the Tenth Schedule. Rehabilitation could fall within post-exploration as defined by the Tenth Schedule, however a question arises whether a contribution to a rehabilitation company or trust would fall under post-exploration activities. This also gives rise to the question as to whether the contributions to a rehabilitation fund could be of a capital nature, in which case it could qualify for the super deductions under paragraph 5 of the Tenth Schedule. (Daniel et al, 2015:18)

However, Olivier & Futter (2015:75) clarifies this uncertainty by explaining that section 23B of the Act provides that a double deduction will not be allowed where a taxpayer qualifies for a deduction or allowance under more than one provision in the Act. They further point out that under the common law principle "only the deduction or allowance specific to the nature of the

expenditure suffered should be allowed". Therefore rehabilitation expenditure would be deducted under section 37A and not again under paragraph 5 of the Tenth Schedule.

3.2.7 Rollover relief and the carry forward of assessed losses

As explained in Chapter 2 under point 2.2.5, paragraph 7 of the Tenth Schedule provides that when an oil and gas company (seller) disposes of an oil and gas right to another company (acquirer), the seller and acquirer may agree to apply either "rollover treatment" or "participation treatment" to the sale transaction.

In terms of the rollover treatment, the selling company is deemed to have sold the oil and gas right for an amount equal to its base cost or tax cost. Therefore, when the rollover treatment is selected, any gain attributable to the selling company is eliminated and the acquiring company is deemed to acquire the right at its base cost or tax cost.

As explained in Chapter 2 under point 2.2.4, paragraph 5 of the Tenth Schedule provides that assessed losses (as defined under section 20 of the Act) incurred by an oil and gas company in respect of exploration and post-exploration may be set off against oil and gas income as defined and income from the refining of gas which was derived in respect of an oil and gas right held by the company.

What is not clear under the rollover treatment is what happens to the carried forward losses of the seller which pertained to the right that is now disposed of. If the right is disposed of then that trade must cease, which may mean that the loss no longer exist.²⁶ In addition, it is not clear whether the loss would continue to be carried forward if the seller holds some other petroleum right. (Daniel et al, 2015:25). Olivier & Futter (2015:74) is however of the opinion that if the seller holds other oil and gas rights or continues to trade, the seller would be able to carry forward the assessed loss.

²⁶ Section 11 of the Act provides that a company should be carrying on a trade in order to deduct any qualifying expenses. In the same way, Section 20 of the Act only allows for the set off of assessed losses of a company which is carrying on a trade.

Furthermore, under paragraph 7 the seller of an oil and gas right could previously elect for the rollover relief to apply. In terms of the current wording of the paragraph, both the seller and the purchases must agree for the rollover relief to apply. This could mean that one of the parties could prevent the rollover relief from applying, which would hinder the objectives of this incentive. (Scholtz, 2015:1)

3.2.8 Uncertainties identified within the MPRDA

The Mineral and Petroleum Resources Development Act 28 of 2002 (MPRDA) is the Act which governs both the hydrocarbon and the mining industry. In their report to the Davis Tax Committee, Daniel et al. identified some inconsistencies between the MPRDA and the oil and gas tax regime, as well as some provisions in the MPRDA which cause confusion.

Two of the issues that were identified are as follows:

- The MPRDA defines “natural oil” and “petroleum” as “any liquid, solid hydrocarbon or combustible gas existing in a natural condition in the earth’s crust”. The definitions of oil and gas in the Tenth Schedule, however, require that the substance must consist primarily of hydrocarbons. This could mean that, if a company owns a production right under the MPRDA and derives income from a petroleum substance as defined in the MPRDA, but the substance does not consist primarily of hydrocarbons, the company could be subject to the mining regime under the Act and not the oil and gas regime, or even partly to both. (Daniel et al, 2015:11).
- A proposed amendment to the MPRDA contains new state participation provisions. Daniel et al. (2015:55) explains that the wording is still a little bit unclear but that the provisions state: “... at least (i) 20 percent “free carry” with no financial obligation for the State; and (ii) further participation at an agreed price, or production sharing agreements”. The free carry means that an interest in exploration and production

activities is allocated to the State without any financial contribution by or obligation for the State (Daniel et al, 2015:55).

The current inconsistent mix of definitions between the MPRDA and the Act, may cause uncertainty for investors with regards to whether the mining tax regime as provided for in the Act or the oil and gas tax regime as provided for in the Act would apply to their investment.

Furthermore, due to the fact that there is uncertainty regarding the new proposed amendment and what the state participation would entail, oil and gas companies are not able to calculate their after tax return on investments. Oil and gas companies will therefore be hesitant to undertake exploration expenditure. (Olivier & Futter, 2015:87)²⁷. This fact was confirmed by Erskine (2015:1) who pointed out that the proposed amendment has given rise to uncertainty which has resulted in investors terminating spending on exploration activities as far as possible.

Nott & Fofar (2015:1) suggest that, as South Africa's mining industry is mature and producing billions of rand in income, the MPRDA should not be governing both the mining industry and the hydrocarbons industry. The hydrocarbon industry is currently in very early stages of production. A separate hydrocarbons Act should rather be formulated, specifically for the upstream oil and gas sector in South Africa.

3.2.9 Conclusion

A number of uncertainties or shortcomings were identified within the Tenth Schedule, namely:

- Uncertainties with regards to the exemption of oil and gas companies in respect of withholding tax on service fees

²⁷ Supported by Deloitte, 2014: 7

- Difficulty in the application of super-deductions due to uncertainties in respect of exploration vs non-exploration expenditure and expenditure of a capital nature versus expenditure of a revenue nature.
- In the event that rollover treatment of participation treatment is not selected on the disposal of an oil and gas asset, uncertainty whether the disposal proceeds will be included in taxable income (in terms of the definition of oil and gas income as per the Tenth Schedule) or only a 66.67% of the capital gain arising from disposal (as per the provisions of the Eighth Schedule).
- Fiscal stability agreements currently contain some shortcomings.
- It appears as though the Tenth Schedule does not provide for any recoupment of the super-deductions if expenditure of a capital nature is redeemed.
- Some uncertainty exists with regards to the application of rollover treatment on the disposal of an oil and gas right and the carry forward of assessed losses in this regard.

Based on the above review of these uncertainties and shortcomings, it is submitted that even though some further consideration and clarification is needed in respect of the issues raised, as a whole the issues do not create uncertainty or instability to such an extent that it would substantially hinder foreign direct investment. The Tenth Schedule still provides very attractive incentives that are generally clear and transparent.

Some issues and uncertainties were also identified within the MPRDA, namely:

- An inconsistent mix of definitions between the MPRDA and the Act, may cause uncertainty for investors with regards to whether the mining tax regime as provided for in the Act or the oil and gas tax regime as provided for in the Act would apply to their investment.
- Uncertainty with regards to a new proposed state participation provision.

On review of these uncertainties, the uncertainties caused by the new proposed state participation amendment to the MPRDA would hinder foreign direct investment as oil and gas companies would not be able to calculate their after tax return on investments (Olivier & Futter,

2015:87)²⁸. This fact is already evident as investors have terminated any further spending on exploration activities due to the proposed amendment (Erskine, 2015:1).

3.3 Chapter conclusion

The Tenth Schedule to the Act was introduced with the main objective of creating certainty and transparency for oil and gas exploration and production in the aim to secure investment.

The Tenth Schedule contains a number of very attractive incentives which would defer the payment of tax for a number of years. It was concluded in Chapter 2 that the incentives are generally clear, transparent and fiscal stability agreements provide the necessary stability.

However, in order to determine whether the Tenth Schedule to the Act achieves its aim of attracting and retaining FDI through certainty and transparency, a review was done of the issues and uncertainties raised by the International Monetary Fund, the Oil and Gas Sub-Committee to the Davis Tax Committee and stakeholders in the oil and gas industry.

After this review, it is submitted that even though some further consideration and clarification is needed in respect of the issues raised, the issues do not create uncertainty or instability to such an extent that it would substantially hinder foreign direct investment.

The Tenth Schedule therefore achieves its aim of certainty and transparency with its clearly set out provisions and fiscal stability agreements and will be effective in attracting and retaining foreign investment.

The current uncertainties raised by the MPRDA (especially with regards to the proposed state participation) could however substantially hinder foreign direct investment. This fact is already

²⁸ Supported by Deloitte, 2014:1

evident as investors have terminated any further spending on exploration activities due to the proposed amendment (Erskine, 2015:1).

The generous tax incentives provided will achieve the aim of attracting foreign direct investment, however, governments need to keep in mind that crude oil and natural gas are valuable assets that can only be exploited once. As resource owner, government must therefore ensure that the fiscal regime is appropriately designed in order to receive the appropriate share of the economic rent generated from extraction of its oil and gas resource (Sunley et al, 2002:1).

Countries are competing with one another to attract foreign direct investment and government should therefore bear in mind that investors have the choice of tax jurisdiction in which they wish to invest. South Africa and Ghana are both developing countries which would like to attract foreign direct investment into their respective countries. Chapter 4 and 5 will investigate how the tax incentives provided by the Tenth Schedule compare to the tax incentives provided by the Ghana oil and gas tax regime in the quest to attract foreign direct investment.

4. CHAPTER 4 – AN OVERVIEW OF THE GHANA OIL AND GAS TAX REGIME

4.1 Introduction

There are two types of generic legal designs that are implemented in a variety of forms in the oil and gas industries around the world. These two types of designs are (Tordo, 2009:8):²⁹

- (iii) Concessions, which are also known as licenses and tax/royalty systems; and
- (iv) Contracts, which constitute production sharing contracts and service agreement contracts.

Countries differ in terms of the available mineral resources, costs involved in exploration and production, and investors' perception of risk. It will therefore be impossible to design one fiscal regime that would suite all countries (Baunsgaard, 2001:30). As a fiscal regime can be replicated by a number of different fiscal instruments, there is no specific reason to prefer a concession system over a production sharing contract. The choice between a concession system and a production sharing contract will depend on the administrative preferences and a structure that is most suitable for the country. (Baunsgaard, 2001:14). The details of fiscal terms can vary widely even between similar types of fiscal systems (Radon, 2011:63).

The legal framework for South African oil and gas companies is regulated by the MPRDA. Oil and gas companies are subject to the ordinary tax rules within the Act, but enjoy certain tax concession within the Tenth Schedule to the Act. The tax regime that governs the South African oil and gas industry is a concession system.³⁰

Baunsgaard (2001:30) points out that production sharing contracts are normally more difficult to negotiate for countries that have fewer successfully developed projects. Compared to other countries in the world, South Africa is ranked 87th in the Proved Oil Reserves list and 76th in the Proved Natural Gas Reserves list according to the Central Intelligence Agency ("CIA")

²⁹ Supported by Baunsgaard, 2001:12

³⁰ See Chapter 1 for a detailed explanation of the concession system

World Factbook (2015). It therefore appears as though it is more appropriate for South Africa to apply a concession system than production sharing system.

This is supported by the fact that countries such as Libya, Qatar, China, Angola and India, who are ranked much more favourably than South Africa in the World Factbook, apply production sharing contracts in their oil and gas tax regimes.

Country	Proved Oil Reserves Ranking	Proved Natural Gas Reserves Ranking
Libya	9	22
Qatar	13	3
China	14	11
Angola	18	41
India	22	23

Once South Africa reaches a more favourable ranking, government could consider changing from a concession system to production sharing contracts. Governments tend to provide very attractive fiscal terms as incentive during exploration phases, but could decide to take these advantages away during the production phase (Laporte & De Quatrebarbes, 2015:9).

Countries are competing with one another for foreign direct investment and it is therefore important for government to recognise that investors, in selecting the country in which they wish to invest, will be mindful of the different tax jurisdictions of each potential country. According to Olivier & Futter (2015:39) countries with less favourable geological conditions (i.e. oil and gas possibilities) will normally offer more attractive fiscal terms.³¹ It is also important to note that investors require a stable investment environment in making the decision to invest in a host country. A stable investment environment will include stability and certainty in the application of the relevant tax law (OECD, 2007:4).

³¹ Supported by Baunsgaard, 2001:26 and Tordo, 2007:15

The most common tax incentives provided by different tax jurisdictions are full expensing of exploration and/or development costs, accelerated depreciation, investment credits and carry-forward of assessed losses (Baunsgaard, 2001:26).

In South Africa, the Tenth Schedule provides a number of very attractive tax incentives in order to attract foreign investment and in Chapter 3 it was concluded that the Tenth Schedule provides the necessary certainty, transparency and stability with its clearly set out provisions and fiscal stability agreements. As governments are in competition with one another to attract foreign direct investment, it may be useful to determine how the attractive tax incentives provided by the Tenth Schedule compare to the tax incentives provided by other jurisdictions.

South Africa and Ghana are both developing countries in Africa and, like South Africa, for the past few years it has been the trade policy of Ghana to attract foreign direct investment by using tax incentives as a strategic tool (ActionAid, 2014: vii). The tax regime that governs the Ghana oil and gas industry is also a concession system.

As mentioned above, according to the Central Intelligence Agency (“CIA”) World Factbook (2015), South Africa is ranked 87th in the Proved Oil Reserves list and 76th in the Proved Natural Gas Reserves list, whereas Ghana is ranked 45th in the Proved Oil Reserves list and 73rd in the Proved Natural Gas Reserves list.

It may appear that South Africa does not have an impressive ranking in the CIA World Factbook, however in the last few years there has been an increased interest in South Africa’s offshore oil and gas potential and nearly all of South Africa’s offshore acreage has been licensed. South Africa’s oil and gas reserves may therefore soon reach a stage where it can no longer be labelled as insignificant (Havemann, 2014:2).

Ghana achieved a more attractive ranking in comparison to South Africa in terms of proved oil reserves. However, in terms of the overall CIA Factbook ranking, Ghana would not be seen as one of the major players in the oil and gas industry with their current ranking. The first

commercial oil find in Ghana was in 2007 which was followed by the commencement of commercial production, in the so called Jubilee-field in 2010. With the significant discoveries made in the Jubilee field, as well as other offshore oil and gas discoveries, Ghana may have the potential to be seen as a major oil and gas producing country in the next few years. (Allotey, 2011: 1).

The above introduction postulates that both South Africa and Ghana have the potential to be on the rise in the oil and gas industry. Both South Africa and Ghana are developing countries in Africa and both countries apply a concession tax regime to their oil and gas industry. It is also evident that both countries wish to attract foreign investment into their respective countries through possible incentive schemes. Ghana is therefore considered to be an acceptable country for comparison. A comparison will be performed between the oil and gas incentives provided by each country in order to determine which incentives may be more attractive to foreign investors. In order to perform the comparison, this chapter will provide an overview of Ghana's oil and gas tax regime and the comparison of incentives will be performed in Chapter 5.

4.2 The Ghana oil and gas tax regime

4.2.1 Introduction

Ghana has four offshore sedimentary basins, namely: Saltpond, Tano, Cape Three Points, and Accra/Keta and one onshore basin called the Voltaian Basin. (Ghana Revenue Authority, 2014: 7). The upstream activities in Ghana will include exploration, evaluation, appraisal, development and production of oil and gas. (Ghana Revenue Authority, 2014: 13)

The Ghana Revenue Authority (2014: 13) define exploration, evaluation and appraisal, development and production of oil and gas, all of which constitute exploration, as follows:

“Exploration – means the search for petroleum by geological, geophysical and other methods, and the drilling of exploration wells.

Evaluation and Appraisal – means analysis of seismic data and other information, and drilling of wells to determine the commerciality of a discovery.

Development – refers to the drilling of development wells, construction and installation of equipment and facilities for production.

Production – refers to the activities undertaken to extract, save, treat and transport oil and gas to storage or offloading points.”

The tax regime governing the Ghana oil and gas industry is a concession system³² with State Participation.³³ As part of the Ghana concession tax regime, government will grant exclusive rights to Contractors to explore and produce in a specific area. The exploration period under the rights granted is split into three phases, namely: the initial exploration, the first extension period and the second extension period. These periods are generally for 7 years, with mandatory relinquishments at the end of the exploration period. (PWC, 2011:7)

Ghana’s oil and gas industry is governed by the following legislation (Ghana Revenue Authority, 2014: 25):

- Ghana National Petroleum Corporation Law, 1983 (P.N.D.C.L 64),
- the Petroleum Exploration and Production Law, 1984 (P.N.D.C.L 84),
- the Petroleum Income Tax Law 1987 (P.N.D.C.L. 188),
- the Internal Revenue Act, 2000 (Act 592),
- the Petroleum Revenue Management Act, 2011 (Act 815) and
- the Petroleum Commission Act, 2011 (Act 821).

³² See Chapter 1 for a detailed explanation of the concession system

³³ State Participation consist of Carried Interest and Additional Interest. See 4.3.3 for detailed description.

The Internal Revenue Act, 2000 (Act 592) provides the general tax law of Ghana and has provisions in respect of income tax, capital gains tax and gift tax.

The Petroleum Income Tax Law 1987 (P.N.D.C.L. 188) (“Petroleum Income Tax Law”), provides for specific tax treatment of specified income of any person engaged in oil and gas activities. Should the Petroleum Income Tax Law not provide for a particular issue with regards to oil and gas activities and income, the provisions of the Internal Revenue Act, 2000 (Act 592) will apply³⁴ (Ghana Revenue Authority, 2014: 33).

The Ghana National Petroleum Corporation Law 1983 (P.N.D.C.L 64) established the Ghana National Petroleum Corporation (“GNPC”). The GNPC acts as the National Oil Company of the upstream oil and gas industry in Ghana. (PWC, 2011:9)

These laws, together with Petroleum Agreements, set out how and when rights to conduct upstream activities can be granted, the rights and obligations of the Contractor and the fiscal regime of the Ghana oil and gas industry (Ghana Revenue Authority, 2014: 28). A Petroleum Agreement is an agreement signed by GNPC, the Government of Ghana and a Contractor.

4.2.2 Petroleum Agreements

Petroleum Agreements provide for taxes to be levied on oil and gas produced, income from petroleum activities for Contractors and Subcontractors, as well as some tax concessions (Ghana Revenue Authority, 2014: 50). The provisions of the Petroleum Agreements are subject to the general laws of Ghana (Ghana Revenue Authority, 2014: 49). Any other income (i.e. income that is not from petroleum activities) earned by Contractors or Subcontractors will be subject to tax under the general laws of Ghana (Ghana Revenue Authority, 2014: 53)

³⁴ This is similar to South Africa’s tax regime as, should the Tenth Schedule not make provision for a specific issue, the issue would be subject to the ordinary tax rules within the Act.

Article 12 of Petroleum Agreements provides that *“No tax, duty, fee or other impost shall be imposed by the State or any Political Subdivision on a Contractor, its Subcontractors or Affiliates in respect of activities related to Petroleum Operations and to the sale and export of Petroleum other than as provided in this Article”*. Therefore only taxes provided for by the Petroleum Agreement will be imposed on oil and gas activities and on the sale and export of petroleum. (Ghana Revenue Authority, 2014: 49).

A Contractor is any person (resident or non-resident) who is a party to a Petroleum Agreement with the State and the GNPC (PWC, 2011:5).

A Subcontractor is any person (resident or non-resident) who provides work or services in Ghana, in connection with a Petroleum Agreement, through a contract with a Contractor (PWC, 2011:6).

The PWC Tax Guide for Petroleum Operation in Ghana (2011:5) defines an Affiliate as *“A company that holds not less than five percent of share capital or voting rights in a company undertaking petroleum operations or any company which controls, is controlled by, or is under common control with any person carrying on petroleum operations.”*

The Petroleum Agreements provide for the following: (Ghana Revenue Authority, 2014: 54):

- Royalties

Royalties are levied on a percentage of gross oil and gas taken from land and sea, regardless of whether the extraction is profitable for the Contractor or not.

- Withholding taxes

Payments made by Contractors and Subcontractors in Ghana, to resident and non-resident suppliers, are ordinarily subject to withholding taxes at different specified rates,

depending on the nature of the transaction (PWC, 2013:39). The transactions subject to withholding tax include supply of goods and services, rent, royalties, insurance and interest payments (PWC, 2011:15). Petroleum agreements provide, however, that the aggregate of payments made by a Contractor to a Subcontractor will only be subject to a withholding tax of 5%. If services are provided by an Affiliate of a Contractor and the services are charged at cost, the withholding tax in respect of such services may be waived.

- Dividend Tax

Petroleum Agreements provide that dividends tax will not apply to Contractors. The result is that dividend income earned by shareholders or investors in upstream petroleum operations will not be subject to dividends tax (EY, 2015: 220).

- Additional oil entitlement

Additional oil entitlement consists of an additional profit tax based on the specific rate of return achieved by Contractors. This ensures that the State participates in any excess profits made by Contractors.

- Surface Rentals

Surface rentals are charged to Contractors based on a per square kilometer of the blocks that have been assigned to them for oil and gas operations.

- Other Rentals

Petroleum Agreements provide for other rentals, including rentals payable on government property and public land, to be applicable to Contractors.

- Petroleum income tax

Petroleum Agreements set out the petroleum income tax applicable to the oil and gas industry in terms of the Petroleum Income Tax Law. A Contractor will be taxed at the corporate income tax rate of 50%, unless the tax rate is specifically provided for in the Petroleum Agreement. Currently, Petroleum Agreements typically reduce the income tax rate to 35% (PWC, 2011:10).

In terms of the Petroleum Income Tax Law, tax will be levied on the taxable income from oil and gas activities. Taxable income is defined as gross income less all allowable deductions. Gross income includes all income from the sale of petroleum, the export of petroleum without sale, as well as income incidental to petroleum activities. Income incidental to petroleum activities will include all income that is effectively connected to petroleum activities (Ghana Revenue Authority, 2014: 62). Income from the sale of petroleum is income derived by the Contractor from the sale of the petroleum that the Contractor is entitled to under a Petroleum Agreement (Ghana Revenue Authority, 2014: 100)

In terms of allowable deductions provided in the Petroleum Income Tax Law, “*Outgoings and expenses wholly, exclusively and necessarily incurred in petroleum operations are generally allowed for tax purposes*” (PWC, 2011: 10). The PWC Tax Guide for Petroleum Operations in Ghana (2011: 10) reflects the following examples of the types of deductions allowed and the types of deductions not allowed under the Petroleum Income Tax Law:

Allowable deductions under the Petroleum Income Tax Law:

- Capital allowance;
- Bad debt and doubtful debts;
- Tax losses brought forward from previous years (indefinitely);
- Rental and royalties;
- Contribution to a pension or provident fund to the extent that the total contribution by both the employer and the employee does not exceed 25% of the total remuneration of the employee; and
- Training and education of Ghanaian citizens and nationals in approved institutions.

Deductions not allowed under the Petroleum Income Tax Law:

- Personal or domestic expenditure;
- Interest, charges, fees on borrowed amount in excess of commercial rate;
- Capital expenditure;
- Expenditure recoverable under an insurance contract;
- Any income tax or profit tax or similar tax; and
- Depreciation.

In terms of capital allowances granted as deductions in Ghana, all expenditure incurred by a Contractor prior to the production stage, whether revenue or capital in nature, will be accumulated as capital expenditure. Any income that is received during the period before production commences, will be deducted from the accumulated capital expenditure. Once production commences, the balance of the accumulated capital expenditure (i.e. the accumulated expenditure less any income earned before production commenced), will be allowed as a capital allowance at a rate of 20% on a straight-line basis over five years (Ghana Revenue Authority, 2014: 81).

The Petroleum Income Tax Law provides that Contractors should segregate petroleum operations between each petroleum agreement (i.e. the law provides for ring-fencing). Therefore, the cost and income from the operations of one petroleum agreement cannot be shifted or transferred to the cost and income from the operations of another petroleum agreement (Ghana Revenue Authority, 2014: 94).

There is a general anti-avoidance rule, provided for in The Petroleum Income Tax Law, which has the effect of preventing revenue loss to the state (Ghana Revenue Authority, 2014: 71). If The Commissioner is of the opinion that the purpose of the transaction was either to avoid/reduce tax or the transaction was not at arm's length between related parties, the Commissioner may use his/her discretion in terms of disregarding the transaction (PWC, 2011:11).

- Exemptions

The Ghana Revenue Authority's presentation on the fiscal regime for the oil and gas industry (2014: 56), set out the following exemptions as provided for under Petroleum Agreements:

- *No export tax on petroleum products exported.*
- *Vessels or other means of transport used to export petroleum produced are not liable for any tax, duty or charge.*
- *No customs duties and taxes on plants, equipment and materials imported to be used solely and exclusively for petroleum operations.*
- *No customs duties and taxes on personal and household effects imported by foreign national employees.*
- *No VAT on plants equipment and materials supplied for petroleum operations*

- Fiscal Stability

In terms of the rights and benefits set out in the Petroleum Agreements, a Contractor shall be entitled to economic and fiscal stability. This results in taxes levied and exemptions allowed in terms of the Petroleum Agreement remaining in place for the entire period that the Petroleum Agreement is applicable.

4.2.3 Other Fiscal Elements

The fiscal regime governing the Ghana oil and gas industry provides for the following additional fiscal elements (Ghana Revenue Authority, 2014: 38):

- Carried interest

GNPC is entitled to hold 10% of any oil and gas operation (on behalf of the State) and will not contribute towards exploration or development expenses, however, it will

contribute towards production expenses. In terms of this carried interest, GNPC (on behalf of the State) is entitled to 10% of any revenue or petroleum distributed to the interest holders of any oil and gas operation. This term “carried interest” essentially means that the Contractor will pay an amount to the GNPC in order to conduct oil and gas operations, without any entitlement to a reimbursement from GNPC. (PWC, 2011:7)

- Additional interest

An additional participation interest will be acquired by GNPC (on behalf of the State) after the commercial discovery of oil and gas. In terms of this interest, GNPC will not contribute towards exploration costs, however it will contribute towards development and production costs. In terms of this additional interest, GNPC will be entitled to an additional participation/share on any revenue or petroleum distributed to the interest holders of any oil and gas operation.

- Capital Gains Tax

In terms of the Internal Revenue Act 2000 (Act 592), any gains from the disposal or realisation of assets are taxable. Currently, there is no capital gains tax on the disposal of depreciable assets by Contractors. Instead, the gain or loss incurred on the disposal of assets will be included in the normal income tax calculation. There is a possible amendment in the pipeline to impose capital gains tax on petroleum operations (i.e. the sale of depreciable petroleum assets) (EY, 2015: 219)

- Training allowances

Training allowances consist of annual payments by Contractors to the GNPC in order to support human resource building and development.

- Technology allowances

Technology allowances consist of a once-off payment made by Contractors to GNPC. This allowance is granted in order to assist GNPC with the procurement of property, plant and equipment which is needed for oil and gas operations.

4.3 Chapter conclusion

The tax regime that governs the South African oil and gas industry is a concession system.³⁵ The Tenth Schedule to the Act provides a number of very attractive tax incentives in order to attract foreign investment (as described in more detail in Chapter 2) and it was concluded in Chapter 3 that the Tenth Schedule provides the necessary certainty, transparency and stability with its clearly set out provisions and fiscal stability agreements.

Governments are in competition with one another to attract foreign direct investment and it may therefore be useful to determine how the attractive tax incentives provided by the Tenth Schedule compare to the tax incentives provided by other jurisdictions.

Both South Africa and Ghana have the potential to be on the rise in the oil and gas industry, both are developing countries in Africa and both countries apply a concession tax regime, with tax incentives, to their oil and gas industry. Ghana is therefore considered an acceptable country for comparison.

From the overview of Ghana's oil and gas tax regime, Ghana will generate revenue from the development of its oil and gas sector through royalties, additional entitlement, rentals, income tax, carried interest, additional interest, training allowances and technology allowances. The tax incentives provided by the Ghana oil and gas tax regime include exemptions from withholding taxes on payments made to parties that are affiliates of Contractors, exemptions from dividends tax, a reduced income tax rate, capital allowances, roll forward of assessed losses and fiscal stability.

³⁵ See Chapter 1 for a detailed explanation of the concession system

Chapter 5 will perform a comparison between the oil and gas incentives provided by Ghana and South Africa in order to determine which incentives may be more attractive to foreign investors.

5. CHAPTER 5 – INCENTIVES PROVIDED BY THE GHANA OIL AND GAS TAX REGIME IN COMPARISON TO THE INCENTIVES PROVIDED BY THE TENTH SCHEDULE

5.1 Introduction

The Tenth Schedule to the Act was introduced with the main objective of creating certainty and transparency for oil and gas exploration and production in the aim to secure investment. The Tenth Schedule contains a number of attractive incentives which would defer the payment of tax for a number of years. It was concluded that the incentives are generally clear, transparent and fiscal stability agreements provide the necessary stability. The Tenth Schedule to the Act would therefore be attractive to foreign investors.

Governments are in competition with one another to attract foreign investment through fiscal incentives. This chapter will therefore aim to establish how the generous incentives provided by the Tenth Schedule (which was introduced in the hopes of securing investment) compare to incentives provided by other tax jurisdictions.

Common incentives used by different fiscal systems include, full expensing of exploration and/or production costs, accelerated depreciation allowances, investment credits, and carry forward of losses (Baunsgaard, 2001:26)³⁶.

For purpose of the comparison, both South Africa and Ghana have the potential to be on the rise in the oil and gas industry, both are developing countries in Africa and both countries apply a concession tax regime to their oil and gas industry. Furthermore, both countries wish to attract foreign investment into their respective countries through possible incentive schemes. Ghana is therefore considered an appropriate country for the comparison.

³⁶ Supported by Tordo, 2007:11

An overview of the Ghana oil and gas tax regime was provided in Chapter 4. This chapter will perform a comparison between the incentives provided by South Africa and Ghana in order to determine which tax jurisdiction would be more attractive to foreign investors (based purely on the tax incentives provided).

5.2 Comparison

In Ghana, the government will generate revenue from the development of its oil and gas sector through the following channels: royalties, additional entitlement, rentals, income tax, carried interest, additional interest, training allowances and technology allowances. In South Africa, government will generate revenue from income taxes and royalties.

The tax incentives provided by the Ghana oil and gas tax regime include:

- a reduced withholding tax rate,
- exemptions from withholding taxes on payments made to parties that are affiliates of Contractors,
- exemptions from dividends tax,
- a reduced income tax rate,
- capital allowances,
- roll-forward of assessed losses and
- fiscal stability.

The tax incentives provided by the South African oil and gas tax regime include:

- exemption from dividends withholding taxes,
- exemption from withholding tax on interest,
- super deductions,
- roll forward of assessed losses,
- rollover treatment and participation treatment in respect of the disposal of oil and gas assets and
- fiscal stability agreements.

5.2.1 Income Tax rate

Petroleum Agreements in Ghana will reduce the Ghana corporate tax rate from 50% to 35% as a form of incentive. In South Africa, the Tenth Schedule does not reduce the corporate tax rate, but provides that it shall not exceed the current corporate tax rate of 28%. Although the South African corporate tax rate is not reduced for the oil and gas industry, a corporate tax rate of 28% will be more attractive to foreign investors than one of 35% in Ghana.

5.2.2 Withholding taxes

In Ghana, payments made by Contractors and Subcontractors to resident and non-resident suppliers are subject to withholding tax at different specified rates. These rates are dependent on the nature of the transaction (PWC, 2013:39). Petroleum agreements provide some relief by subjecting the aggregate payments made by a Contractor to a Subcontractor to withholding tax of 5%. In the instance where services are provided at cost by an Affiliate of a Contractor, the withholding tax in respect of such services may be waived.

In South Africa, the Act provides for withholding tax on interest payments made to foreign persons. An incentive is provided in the Tenth Schedule for oil and gas companies in the form of a 0% withholding tax on interest paid in respect of loans, which were applied to fund expenditure of a capital nature in respect of exploration and post-exploration. Currently there is no withholding tax on services.

As the above comparison provides, from a foreign investors view point, South Africa has a more favourable withholding tax regime than Ghana.

5.2.3 Dividends tax

In Ghana, Petroleum Agreements provide that dividends tax will not apply to Contractors. The result of this provision is that dividend income earned by shareholders or investors in upstream

petroleum operations will not be subject to tax. Similarly, the Tenth Schedule in South Africa provides that any dividends paid out of the oil and gas income³⁷ of a company will be subject to a dividends withholding tax rate of zero.

It is thus evident from the legislation of both countries that dividend payments in the oil and gas sector are exempt from dividends tax as an incentive.

5.2.4 Capital Allowances

In Ghana all expenditure incurred by a contractor prior to the production stage, whether revenue or capital in nature, will be accumulated as capital expenditure. Any income that is received during the period before production commences, will be deducted from the accumulated capital expenditure. Once production commences the balance of the accumulated capital expenditure (i.e. the accumulated expenditure less any income earned before production commenced) will be allowed as a capital allowance at a rate of 20% on a straight-line basis over five years.

In South Africa, the Tenth schedule provides that exploration expenditure of a capital nature qualifies for a super deduction of 200% and post-exploration expenditure of a capital nature qualifying for a super deduction of 150%. These deductions are granted in the year in which the expenditure is incurred. The generous super-deductions act as an incentive for investors to invest in high-risk, high cost capital expenditure.

In comparison, the super deductions provided in South Africa (which are allowed as an immediate deduction) will prove more attractive to foreign investors than the deduction of capital expenditure over a 5 year period provided in Ghana.

³⁷ Oil and gas income is defined as receipts and accruals derived from exploration and post-exploration in respect of any oil and gas right or the leasing or disposal of any oil and gas right.

5.2.5 Assessed losses

South Africa and Ghana allow assessed losses from oil and gas operations to be carried forward to subsequent years (indefinitely).

In South Africa, if any amount remains post offsetting of the assessed loss against oil and gas income, 10% of the remaining assessed loss may be set off against other income (i.e. income other than income from oil and gas activities).

The fact that 10% of the assessed loss could be set off against other income (income other than income from oil and gas activities), will be attractive to foreign investors, however, generally, oil and gas companies do not engage in activities other than oil and gas activities and thus this incentive would not necessarily be a convincing incentive on its own.

5.2.6 Capital Gains Tax

In Ghana there is no capital gains tax on the disposal of depreciable assets by Contractors. The gain or loss made on the disposal of the assets will be included in the normal income tax calculation.

In South Africa the Tenth Schedule provides that when an oil and gas company disposes of an oil and gas right to an acquirer, the oil and gas company and the acquirer may agree to apply either “rollover treatment” or “participation treatment” to the sale transaction.

Under rollover treatment the selling company is deemed to have sold the oil and gas right for an amount equal to its base cost³⁸ or tax cost.³⁹ Therefore, when rollover treatment is selected,

³⁸ The base cost as determined by paragraph 20 of the Eighth Schedule to the Act.

³⁹ The tax cost as determined by section 22 of the Act.

any gain for the selling company is eliminated and the acquirer is deemed to acquire the right at its base cost or tax cost.

Under the Participation treatment the selling company treats all gains made under the sale transaction as gross income revenue, regardless of whether the oil and gas right was held as a capital asset or as trading stock. The acquirer will then be allowed to deduct from its oil and gas income an amount equal to the amount included in the gross income of the selling company. Therefore, the effect of participation treatment is that any loss from oil and gas income in the selling company would be transferred from the seller to the purchaser. The participation treatment will therefore most likely be chosen when the seller has an assessed loss, as the seller can utilise the assessed loss and the purchaser can deduct the capital expense immediately (Moolman, 2012:53).

From a foreign investor's point of view, it would appear more attractive to have the option of either the rollover treatment or the participation treatment which South Africa offers, than to include the gain from the sale of an asset in taxable income as would be the case under the Ghana oil and gas tax regime.

5.2.7 Fiscal Stability Agreements

Ghana and South Africa allow for fiscal stability agreements which aim to provide a stable investment environment required by foreign investors in the oil and gas industry. This stable investment environment is a very attractive incentive for foreign investors. Olivier & Futter (2015:77) confirms that "*fiscal stability is essential to secure investor confidence in the oil and gas environment where the capital outlay is significant and the geological uncertainty is pervasive.*"

Summary of incentives provided by Ghana and South Africa

Incentive	Ghana	South Africa
Income tax rate	Petroleum Agreements reduce the corporate income tax rate from 50% to 35%.	Through the Tenth Schedule, the corporate tax rate applicable to oil and gas companies will not exceed the current corporate tax rate of 28%.
Withholding taxes	Withholding tax on amounts paid by Contractors to Subcontractors in respect of various transactions is capped at 5%. Withholding tax on services payments to an affiliate could be waived.	Withholding tax on interest, in respect of loans which were applied to fund expenditure of a capital nature in respect of exploration and post-exploration, is limited to zero percent. There is currently no withholding tax on services.
Dividends tax	Petroleum agreements provide that there will be no dividends tax applicable to dividends paid by Contractors.	The Tenth Schedule limits dividends withholding tax to zero percent in respect of dividends distributed out of oil and gas income.
Capital allowances	Accumulated capital expenditure is allowed to be deducted over five years at a rate of 20% per year once production commences.	Capital expenditure is allowed to be deducted in full in the year in which it is incurred. There is a further 100% deduction allowed for exploration expenditure of a capital nature as well as a further 50% for post-exploration expenditure of a capital nature.

Assessed losses	Assessed losses may be carried forward indefinitely.	Assessed losses may be carried forward indefinitely, however, if any amount remains after the offsetting of the assessed loss against oil and income, 10% of the remaining assessed loss may be set off against other income (i.e. income other than income from oil and gas activities).
Capital gains tax	There is currently no capital gains tax applicable to Contractors. The gain or loss from the sale of the asset will be included in the normal income tax calculation.	Upon disposal of an asset, oil and gas companies and the acquirer of the asset may agree to apply either rollover treatment or participation treatment which will either result in no tax arising from the sale of the asset (under rollover treatment) or the seller being able to utilise its assessed loss (under participation treatment).
Fiscal Stability	The fiscal stability clause contained in Petroleum Agreements provides that the taxes levied and exemptions allowed in terms of the Petroleum Agreement will remain in place for the entire period that the Petroleum Agreement is applicable.	Fiscal stability agreements will guarantee that the provisions of the Tenth Schedule, as at the time that the fiscal stability agreement was entered into, will apply for the duration of the period that the oil and gas right is held by the company.

5.3 Chapter conclusion

Foreign direct investment plays an important role in the oil and gas industry and one of the methods of attracting foreign investment is for government to offer tax incentives. As countries are in competition with one another for foreign direct investment, a comparison was performed between the incentives provided by South Africa and Ghana in order to determine which tax jurisdiction would be more attractive to foreign investors (based purely on the tax incentives provided).

South Africa and Ghana, through their concession systems, provide very similar and attractive tax incentives and both countries provide fiscal stability within their tax regimes which aims to create the stable investment environment required by investors. There are however a number of differences in the methods used to collect revenue.

In Ghana's oil and gas industry, government will generate revenue from the development of its oil and gas sector through royalties, additional entitlement, rentals, income tax, carried interest, additional interest, training allowances and technology allowances. In South Africa's oil and gas industry, government will generate revenue from income taxes and royalties.

The tax incentives provided by the Ghana oil and gas tax regime include exemptions from withholding taxes on payments made to parties that are affiliates of Contractors, exemptions from dividends tax, a reduced income tax rate, capital allowances, roll forward of assessed losses and fiscal stability.

The tax incentives provided by the South African oil and gas tax regime include exemption from dividends withholding taxes and withholding tax on interest, super deductions on capital expenditure, roll forward of assessed losses, rollover treatment and participation treatment for disposal of oil and gas assets, and fiscal stability.

Upon comparison between each of the incentives provided by the two countries, it appears that, from a foreign investor's point of view when considering tax regimes in isolation, South Africa has more favourable and attractive incentives than Ghana. Furthermore, Ghana has a higher corporate tax rate and a number of additional methods of collecting revenue from Contractors, such as additional entitlement, rentals, carried interest, additional interest, training allowances and technology allowances.

In the making a decision to invest, should an investor purely look at the tax incentives and the tax regime provided (i.e. in this case assuming that the geological conditions of the two countries are the same), from the comparison done, it appears that investing in the South African oil and gas industry would be the chosen over investing in the Ghana oil and gas regime.

In South Africa, government mainly collects revenues from the oil and gas industry through income tax and royalties, but also collects through license fees on acreage. Government has also proposed a 20% free carry as collection method.⁴⁰ With income tax and royalties as the main collection methods for revenue, in comparison to Ghana with additional entitlement, rentals, carried interest, additional interest, training allowances and technology allowances, South Africa should guard against loss in tax revenues due to over-generous tax incentives. Crude oil and natural gas are valuable assets that can only be exploited once. Government, as the resource owner, therefore has an important task of generating the appropriate revenues, through its fiscal regime, from the extraction of oil and gas. (Sunley et al, 2002:1)

Olivier & Futter (2015:39) confirm that countries with less favourable geological conditions (i.e. oil and gas possibilities) will normally offer more attractive fiscal terms. Should significant discoveries be made in South Africa, the geological situation would be more favourable and South Africa should potentially consider stricter fiscal terms and less generous incentives in order to generate the appropriate revenue from development of its natural resources.

⁴⁰ See 2.3.4 for further detail regarding the 20% free carry.

6. CHAPTER 6 – CONCLUSION

6.1 Introduction

The oil and gas industry is an important industry for South Africa as the extraction of oil and gas resources holds strategic significance not only for governments but for the global economy (Yergin, 2012:229 – 233). The discovery and production of oil and gas has the potential to decrease South Africa's dependency on external sources to satisfy its energy needs and to generate substantial foreign revenue for the country (Clegg & Steenkamp, 2007:1).

The exploration for oil and gas is a medium to long term exercise, one which is extremely costly (Futter, 2010:1). The oil and gas industry would also require stable and long term investment and therefore foreign direct investment plays an important role in this industry (Antolin & Cendrero, 2013:715). Furthermore, a lack of skilled labour is a common challenge in the oil and gas sector over the African continent and foreign direct investment could result in international companies providing the skilled labour needed (PWC, 2014:6).

Governments would therefore like to attract foreign direct investment to the oil and gas sector and one of the methods used to achieve this goal is for governments to offer tax incentives (OECD, 2007:5). Due to the length and costs involved in exploration projects, investors would require a stable investment environment and it is important for government to ensure that the incentives provided are transparent, simple, provide certainty and create stability.

Two types of generic legal designs, namely concession systems and contracts (which include production sharing contracts) are implemented in a variety of forms in the oil and gas industries around the world. (Tordo, 2009:8):⁴¹ The legal framework for oil and gas companies

⁴¹ Supported by Baunsgaard, 2001:12

in South Africa is regulated by the MPRDA and the tax regime governing the South African oil and gas industry is a concession system.⁴²

Production sharing contracts are normally more difficult to negotiate for countries with fewer successfully developed projects (Baunsgaard, 2001:30). According to the Central Intelligence Agency (“CIA”) World Factbook (2015), South Africa does not have a favourable ranking in comparison to other countries in respect of proved oil reserves and proved natural gas reserves. It therefore appears as though it is more appropriate for South Africa to apply a concession system than production sharing system.

Oil and Gas companies are subject to the ordinary tax rules within the Act, but enjoy certain tax concessions within the Tenth Schedule to the Act which aims to incentivise investment. The Tenth Schedule tax regime was formulated and brought into use in November 2006 to replace the previous investment regime for oil and gas companies which was established in terms of the OP26 prospecting lease agreements. Around June 2007, the OP26 regime was expected to terminate and uncertainty arose around the renewal of the fiscal provisions that were contained in the OP26 regime. This uncertainty led to a number of companies postponing their investment in the South Africa oil and gas regime until the uncertainty was resolved (National Treasury, 2006:15). This reiterates the importance of certainty in a tax regime for investors. The Explanatory Memorandum on the Revenue Laws Amendment Bill (2006: 15) explains that the main reason for introducing the Tenth Schedule was to create certainty and transparency for oil and gas exploration and production in the hope of securing investment.

South Africa could soon reached a stage where it's oil and gas resources can no longer be labelled as insignificant as nearly all of South Africa's offshore acreage has been licensed in the last few years.

⁴² See Chapter 1 for a detailed explanation of the concession system

6.2 Summary of findings

Considering the current growth potential of South Africa's oil and gas industry and the fact that foreign investment is important for the development of the oil and gas sector, the purpose of this dissertation was to establish whether the Tenth Schedule to the Income Tax Act is effective in creating certainty and transparency in order to attract and retain foreign investment. Furthermore, the issues and uncertainties currently faced in the Tenth Schedule were reviewed to establish whether they could potentially hinder foreign investment. Finally, as countries are in competition with one another to attract foreign investment, a comparison was performed between the incentives provided by the Tenth Schedule and the incentives provided by Ghana's oil and gas tax regime.

6.2.1 Incentives provided by the Tenth Schedule

The main reason for introducing the Tenth Schedule was to create certainty and transparency for oil and gas exploration and production in the hope to secure investment. The tax incentives contained in the Tenth Schedule, which are used as a method to attract foreign investment, include an exemption from dividends withholding tax and withholding tax on interest, super-deductions on capital expenditure, the roll forward of assessed losses, rollover treatment and participation treatment in respect of the disposal of oil and gas assets and, fiscal stability agreements.

From the review performed on these incentives, it was found that the incentives are very attractive and could defer the payment of tax for a number of years. The incentives are also clear, transparent and the fiscal stability agreements provide the necessary stability. The incentives would competitively increase the after tax return of investors in the oil and gas industry compared to investors in other industries in South Africa and as investors would know the income tax consequences of their investment they will be able to plan their financial strategies in advance (Moolman, 2012:58).

6.2.2 Issues and uncertainties currently faced within the Tenth Schedule

The following issues were raised by by the International Monetary Fund, the Oil and Gas Sub-Committee to the Davis Tax Committee and stakeholders in the oil and gas industry:

- There appears to be no relief from the proposed withholding tax on service fees even though there is relief from dividends withholding tax and withholding tax on interest.
- The fiscal stability agreement provisions contain some uncertainties.
- There are uncertainties in the application of super-deductions to exploration and post-exploration capital expenditure with regards to the nature of exploration and post-exploration expenditure and the meaning of capital expenditure.
- There is uncertainty regarding the deductions allowed for contributions to rehabilitation funds.
- It appears as though there is no recoupment of redeemed capital expenditure (expenditure which was previously deducted from the taxable income of an oil and gas company).
- There are uncertainties in the application of rollover relief and the carry forward of assessed losses.
- Some uncertainty exists regarding the inclusion rate of capital gains in the oil and gas industry.

After a review of the issues raised in respect of the Tenth Schedule provisions, it was found that even though some further consideration and clarification is needed in respect of the issues raised, the issues do not create uncertainty or instability to such an extent that it would hinder foreign direct investment. The Tenth Schedule therefore still achieves its aim of certainty and transparency with its clearly set out provisions and fiscal stability agreements and is effective in attracting and retaining foreign investment.

6.2.3 A comparison between the tax incentives provided by the Ghana oil and gas tax regime and the Tenth Schedule

The tax incentives provided by the Ghana oil and gas tax regime and the tax incentives provided by the Tenth Schedule can be summarised as follows:

Incentive	Ghana	South Africa
Income tax rate	Petroleum Agreements reduce the corporate income tax rate from 50% to 35%.	Through the Tenth Schedule, the corporate tax rate applicable to oil and gas companies will not exceed the current corporate tax rate of 28%.
Withholding taxes	Withholding tax on amounts paid by Contractors to Subcontractors in respect of various transactions is capped at 5%. Withholding tax on services payments to an affiliate could be waived.	Withholding tax on interest, in respect of loans which were applied to fund expenditure of a capital nature in respect of exploration and post-exploration, is limited to zero percent. There is currently no withholding tax on services.
Dividends tax	Petroleum agreements provide that there will be no dividends tax applicable to dividends paid by Contractors.	The Tenth Schedule limits dividends withholding tax to zero percent in respect of dividends distributed out of oil and gas income.
Capital allowances	Accumulated capital expenditure is allowed to be deducted over five years at a rate of 20% per year once production commences.	Capital expenditure is allowed to be deducted in full in the year in which it is incurred. There is a further 100% deduction allowed for

		exploration expenditure of a capital nature as well as a further 50% for post-exploration expenditure of a capital nature.
Assessed losses	Assessed losses may be carried forward indefinitely.	Assessed losses may be carried forward indefinitely, however, if any amount remains after the offsetting of the assessed loss against oil and income, 10% of the remaining assessed loss may be set off against other income (i.e. income other than income from oil and gas activities).
Capital gains tax	There is currently no capital gains tax applicable to Contractors. The gain or loss from the sale of the asset will be included in the normal income tax calculation.	Upon disposal of an asset, oil and gas companies and the acquirer of the asset may agree to apply either rollover treatment or participation treatment which will either result in no tax arising from the sale of the asset (under rollover treatment) or the seller being able to utilise its assessed loss (under participation treatment).
Fiscal Stability	The fiscal stability clause contained in Petroleum Agreements provides that the taxes levied and exemptions allowed in terms of the	Fiscal stability agreements will guarantee that the provisions of the Tenth Schedule, as at the time that the fiscal stability agreement

	Petroleum Agreement will remain in place for the entire period that the Petroleum Agreement is applicable.	was entered into, will apply for the duration of the period that the oil and gas right is held by the company.
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The Ghana oil and gas tax regime and the Tenth Schedule provide similar tax incentives. Both countries provide fiscal stability agreements within their tax regimes which could provide investors with the stable investment environment that they require.

In comparison it appears that, from a foreign investor's point of view, the incentives provided by the Tenth Schedule are more favourable and attractive than those provided by the Ghana oil and gas tax regime. Ghana also provides for a higher corporate tax rate and a number of additional methods of collecting revenue from Contractors, such as additional entitlement, rentals, carried interest, additional interest, training allowances and technology allowances which would make the Ghana oil and gas tax regime less favourable in comparison to the Tenth Schedule.

In making a decision to invest, should an investor purely look at the tax incentives and the tax regime provided (i.e. in this case assuming that the geological conditions of the two countries are the same), from the comparison done, it appears that investing in the South African oil and gas industry would be chosen over investing in the Ghana oil and gas regime.

With income tax and royalties as the main collection methods for revenue, in comparison to Ghana with additional entitlement, rentals, carried interest, additional interest, training allowances and technology allowances, South Africa should guard against loss in tax revenues due to over-generous tax incentives. Crude oil and natural gas are valuable assets that can only be exploited once. Government, as the resource owner, therefore has an important task of generating the appropriate revenues, through its fiscal regime, from the extraction of oil and gas. (Sunley et al, 2002:1)

6.3 Overall conclusion

From a review of the tax incentives provided by the Tenth Schedule, it appears as though the Tenth Schedule to the Income Tax Act achieves its aim of providing sufficient certainty and transparency in order to attract and retain foreign investment in the oil and gas industry. Furthermore, after consideration of the issues and uncertainties currently faced in the Tenth Schedule it is concluded that the issues and uncertainties would not create overall uncertainty or instability to such an extent that it will necessarily hinder foreign direct investment. The Tenth Schedule to the Act is therefore effective in attracting and retaining foreign investment. Finally, in comparison, from a foreign investor's point of view, the incentives provided by the Tenth Schedule are more favourable and attractive than those provided by the Ghana oil and gas tax regime.

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