Natural Resource Governance Institute

Getting a Good Deal: Ring-fencing in Ghana

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SUMMARY

Challenge	Introducing a tax regime that allows the government to realize the full value of its resources and attract investment, while taking into consideration the changing circumstances and difficulties in administering such policies (Precept 4 of the Natural Resource Charter[1]).
Country and period of focus	Ghana, 2010-2015
Challenge in country	Securing tax revenues early on from first large commercial oil discovery while attracting further investment into the sector.
Core decisions	Tax rules originally allowed extractive companies to consolidate income and deductions across different projects. The interpretation of the law left room for ambiguity.
Implications of decisions	The tax rules provided incentives to companies to further invest in the sector, yet the rules also contributed to delay in payment of corporate income tax.
Policy decisions, implementation and governance	The tax rules were amended in 2015 to require companies to calculate chargeable income according to production fields in the oil sector. The amended law also clarified interpretations for the mining sector.
Did it work?	The new rules will not apply retrospectively to current investments. Effects on new investments are yet to be seen.
Quantified losses	An audit is currently underway to determine the impact of previous cost deductions on tax revenues and whether these were legally permissible.
Lessons learned	By introducing ring-fencing rules, governments must be aware of the need to balance the objectives of early revenues versus future revenues. By preventing investors from obtaining a deduction against current income, governments speed up income tax collection but they may also delay further investment and exploration, reducing the future tax base. While ring-fencing may be a necessary safeguard against tax base erosion, governments must consider the various trade-offs when deciding whether to ring-fence, and if so, how tightly the ring-fence should be drawn.

ABOUT THE SERIES

This is one of a series of case studies that illustrates the principles of the Natural Resource Charter. The charter is a tool used by governments and societies seeking to better harness the opportunities created by extractive resources.

1 Natural Resource Charter http://www.resourcegovernance.org/approach/natural-resource-charter

Tax authorities in developing countries are faced with great challenges and difficult choices when designing and administering tax regimes for the extractive sector. Precept 4 of the Natural Resource Charter recommends putting in place a tax policy that realizes the full value of potential revenue from resources and promotes investment, while also taking into consideration the changing circumstances and difficulties in administering such policies. One particular challenge relates to the design and use of ring-fencing provisions as part of the fiscal regime.

THE CHALLENGE: THE DOUBLE-EDGED SWORD OF RING-FENCING

In most sectors, corporate income tax is generally levied at entity level. However, in the extractive sector it is possible that companies will have multiple activities within a single country, creating opportunities for tax optimization; specifically, a company may use losses incurred in one project (for example, during exploration for a new mine), to offset profits earned in another project. This is referred to as "sideways relief". Sideways relief is normal practice, consolidation of income may even encourage exploration and investment. However, for developing countries whose main source of revenue is corporate income tax, any delay in payment may have major consequences for the timing of government expenditure.[2] This is particularly marked in the extractive industry where large amounts of capital expenditure are immediately deductible, making it possible to delay paying income tax for many years.

Ring-fencing is one way of limiting income consolidation for tax purposes. According to the International Monetary Fund (IMF), ring-fencing can broadly be defined as a "limitation on consolidation of income and deductions for tax purposes across different activities, or different projects, undertaken by the same taxpayer." This practice is common to resource-rich countries. In sub-Saharan Africa, South Africa limits deductible expenditure of a mine to the taxable income of that specific mine, while in Tanzania, losses incurred in one mine (defined as a mining license area) cannot be offset against those of another mine even where both mines belong to the same entity.

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Despite widespread use, ring-fencing must be approached with caution. It has the potential to speed up the payment of corporate income tax, yet it may also deter further exploration and development, limiting the future tax base. For example, the inability to obtain a deduction against current income may prevent existing operators from embarking on further exploration outside the ring-fenced area, thereby inhibiting industry growth and reducing potential government revenue over time. According to the IMF, oil and gas companies see ring-fencing as a major disincentive. In Indonesia, for example, companies have repeatedly called for the government to relax its ring-fencing provision.[3] Consequently, governments must balance the need for early revenues, against increasing total revenue collection over the longer-term.

2 OECD, *Two-part Report to G20 Development Working Group on the Impact of BEPs in Low-income Countries,* (2014) pg. 14.
3 IMF, *Tax Treatment of the Oil Sector,* (2002) pg.5.

THE OUTCOME: GHANA'S EXPERIENCE OF RING-FENCING

Box 1. Alleged consolidation of income from Jubilee Fields

Ghana began to pump its first commercial oil in 2010, following the discovery of the offshore Jubilee Field in 2007. This discovery was expected to change Ghana's future, however, results have been disappointing. This is in part due to falling oil prices and oversized expectations, but also due to delays in income tax collection.

The Jubilee Field straddles two concession areas: West Cape Three Points (WCTP) and the Deep Water Tano (DWT). Both concessions are developed through a joint venture between Tullow Oil, Kosmos, Anadarko, PetroSA, and the Ghana National Petroleum Company (GNPC). Jubilee operations began in 2010, and there has since been additional development in oil and gas fields in West Cape and DWT: these are referred to as the MTA Development Area, and the TEN Development Area respectively. In both cases first-oil is expected in mid-2016.

In 2012, the first year that income tax was paid for Jubilee Field, the Ghana Revenue Authority (GRA) collected US $217 million, increasing to approximately US $284 million for the 2013 financial year.[1] It was initially projected to be higher, but during the same period the GRA found that the contractors for both WCTP and DWT had offset exploration and development costs for TEN and MTA against profits generated from the Jubilee Field. Cost deductions for TEN and MTA were made again in 2014.

An audit is currently underway. Until it is complete, there are no conclusive findings as to whether these deductions were permitted. However, it is worth noting that the Jubilee Partners (the companies participating in the joint venture) are currently contesting the GRA's claims on the basis that Section 38(2) of the Petroleum Income Tax Act does not amount to a ring-fencing provision. Regardless of the outcome of the audit, the case clearly underscores the importance of having unambiguous legislation, in particular where it relates to anti-avoidance measures.

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Ghana has adopted a demanding approach to ring-fencing for both mining and petroleum operations. The new Income Tax Act sets outs a definition for a mining ring-fence (which was missing in the Internal Revenue Act of 2012), and establishes a restrictive ring-fence for the petroleum sector. The new provisions may not apply to existing mining and petroleum agreements, which are stabilized, however new investors will be required to comply.

Mining

The purpose of the new Income Tax Act with respect to ring-fencing around mining, is simply to confirm the agreed definition of a "separate mineral operation" which was missing in the previous Internal Revenue Act of 2012. Under the Internal Revenue Act, ring-fencing was meant to happen around a "mining area," however this was not clearly defined. At the time, mining companies were extremely concerned about the practicalities of ring-fencing mining pits, as well as surface versus underground mines. After several meetings, a consensus was reached between the government and industry that the ring-fence area for tax purposes is the mine, and that more than one mine cannot be put together. According to Section 74 of the new Income Tax Act, a separate mineral operation is defined as a mineral operation pertaining to each mine and a mineral operation with a shared processing facility. Companies have deemed this definition to be more feasible than previous proposals.

While this definition may be more achievable, there are still some outstanding issues:

- The new Income Tax law does not provide a definition of a "shared processing facility." This may be broadly understood in practice, however legal interpretation may prove an obstacle to effective implementation.
- It is unclear whether the authors of the law intended for Section 78(1)(a)(b) to be conjunctive, the effect being that a mineral operation shall only constitute a separate operation where there is a shared processing facility, which may not always be the case. Correct drafting of the clause should be on a disjunctive basis whereby a separate mineral operation may be defined as a mineral operation pertaining to each mine, or a mineral operation with a shared processing facility. In this way either definition is sufficient alone.

Petroleum

Ring-fencing in the petroleum sector has been more complex. According to the Petroleum Income Tax (PIT) Law of 1987, "gross income" is defined as the income derived from the sale, or export without sale of petroleum, under a petroleum agreement before making the deductions for the purpose of calculating chargeable income. While not labeled a ring-fencing provision, this requirement means that consolidation of income and deductions is limited to the petroleum agreement area. A strict interpretation would be that the contractors for DWT and WCTP are, in effect, required to ring-fence their respective petroleum agreement areas for tax purposes but this interpretation has been subject to debate.[4]

The new income tax law establishes an explicit, and more demanding, petroleum ring-fence, in order to further disaggregate income. Under the new law, a separate petroleum operation is defined as authorized activities, pertaining to a petroleum right.[5] A petroleum right is defined as the right to conduct petroleum operations under a petroleum agreement. This means that within the context of a single petroleum right, numerous separate petroleum operations may exist and each is taxed independently. Following this, the three separate production fields within the DWT and WCTP respectively, would be taxed separately; although in this case the ring-fence won't apply retrospectively.

4 Amoako-Tuffour, J. and Owusu-Ayim J., "An Evaluation of Ghana`s Petroleum Fiscal Regime", *Ghana Policy Journal* Volume 4, (2010) http://ieagh.org/wp-content/uploads/2014/07/gpj-v4-art1.pdf

5 Section 64 of the new Income Tax Act 2015.

The reasons for the new, more demanding ring-fence are threefold:

First, the PIT law does not mention ring-fencing explicitly, despite the fact that the method prescribed for calculating "gross income" may achieve a similar result. Consequently, there is ambiguity in interpretation of the law and a lot of pressure from civil society to make ring-fencing of petroleum operations a specific requirement in the new Income Tax law. In particular, the 2013 Ghana Extractive Industries Transparency Initiative (GHEITI) report emphasized the need to adopt similar ring-fencing provisions introduced in the mining industry in 2012, for oil and gas.[6]

Second, the GRA was concerned to limit consolidation of income and deductions for tax purposes across different activities within each petroleum agreement area, rather than on the basis of the agreement area itself as in the PIT law. DWT and WCTP each contain three oil fields; by disaggregating income on an activity basis corporate income tax should be paid earlier. Ghana's decision is not without precedent. Some countries choose to ring-fence oil and gas activities, whereas others ring-fence individual contract areas or projects.[7] Given that the various oil fields within DWT and WCTP are yet to commence production, it is difficult to determine whether the new ring-fence is necessary, or whether robust enforcement of the PIT law would have been sufficient. Regardless, given taxpayer compliance issues with respect to the calculation of "gross income," and general administrative difficulties concerning collection of corporate income tax, it is possible to see why the GRA might anticipate the need for a more restrictive ring-fence.

Third, the need for early revenues from petroleum has become even more relevant given Ghana's budget deficit. According to the Natural Resource Governance Institute (NRGI), this deficit has been caused by a combination of falling oil prices and poor public financial management.[8] The impact of the oil shortfall was estimated at US $430 million,[9] however the total deficit is much larger. Consequently, expediting up the collection of corporate income tax is a major priority for the GRA and prompted the decision to introduce a demanding ring-fence.

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6 GHEITI Annual Report (2013).
7 IMF, *Tax Treatment of the Oil Sector*, (2002) pg.5.
8 Mark Evans, "Ghana, Fiscal Responsibility Remains Elusive Even as Oil Flows", Natural Resource Governance Institute (2015) http://www.resourcegovernance.org/news/blog/ghana-fiscal-responsibility-remains-elusive-even-oil-flows.
9 David Mihalyi and Samuel Bekoe, "Forecasting Ghana's Oil Revenues for the 2015 Budget", Natural Resource Governance Institute, (2014) http://www.resourcegovernance.org/sites/default/files/nrgi_ForecastingOilRevenues_2015GhanaBudget.pdf

OUTCOMES

Challenges associated with administering the extractive industry tax regime, particularly corporate income tax, are the backdrop to Ghana's ring-fencing reforms. As the name suggests, corporate income tax is imposed on the income of corporate entities; if a company can reduce its chargeable income they also minimize their tax bill. Consequently, companies will adopt various tax planning strategies that aim to exploit gaps and loopholes in order to artificially shift profits to locations with more favorable tax regimes. This is not unique to the extractive sector, however capital allowances in particular create a temptation to overestimate deductible expenditure, increasing the risk of tax base erosion. With respect to extractive companies, the GRA has difficulties evaluating intra-group payments, as well as deductible expenditure. These difficulties emanate from a lack of technical expertise and industry experience; poor coordination between the GRA and industry regulators, in this case the Mineral and Petroleum Commissions; a lack of relevant comparable data to benchmark expenditure; and limited access to tax information from other jurisdictions.

Box 2. What does the new income tax law mean for Jubilee Fields?

The PIT law governs the DWT and WCTP petroleum agreements. Consequently, the new petroleum ring-fence has no role in determining whether the alleged transfer of costs from DWT and WCTP to Jubilee was legal or not.

Regardless, the contractors may still be in breach of their obligations under the PIT law. According to the definition of "gross income," the contractors for DWT and WCTP must calculate gross income on the basis of their respective petroleum agreement areas, not on a consolidated basis. Consequently, if the contractors have offset TEN and MTA costs from Jubilee Field profits, they may be in breach of this requirement.

LESSONS LEARNED

Ring-fencing is an important measure to close a tax loophole and prevent companies from delaying payment of income tax. This is particularly important for developing countries that have small revenue bases and are highly dependent on corporate income tax from the extractive sector.

In developing a ring-fencing policy it is necessary to consider the following:

1. **Ring-fencing may limit investment.** Ghana has elected to introduce a particularly restrictive ring-fence in the case of the petroleum sector. As yet, it is unclear whether this was a necessary step and what impact it may have on future investment. Experience elsewhere suggests that ring-fencing can discourage investment, if the mineral and petroleum assets are not particularly attractive.[10]

2. **There are different ring-fences to choose from, some more restrictive than others.** There are two main types of ring-fences to decide between. The first applies to individual contract areas or projects, as in the case of Ghana's PIT Act. The second applies to activities, or production areas, as in the new Income Tax Act. The second approach further disaggregates income and deductions.

3. **There are trade-offs when deciding whether to ring-fence, and what form it should take.** On the one hand, ring-fencing may discourage exploration and investment, reducing total revenue over the longer-term. However, for low-income countries such as Ghana, the importance of early revenues, as well as difficulties administering corporate income tax, and the problem of aggressive tax planning by companies, may warrant a particularly demanding approach to ring-fencing. Governments must consider these trade-offs carefully in deciding whether to ring-fence and what type of ring-fence to adopt.

4. **Regardless of which ring-fence is chosen it must be clearly defined in the law.** As the experience of Ghana shows, the first attempt at ring-fencing in the Internal Revenue Act was not clear, creating unnecessary conflict between mining companies and the government. The new Income Tax law provides a clearer definition of "separate mineral operation," however differences of interpretation may still arise with respect to "shared processing facility." Irrespective of which type of ring-fence is chosen, clear criteria must be developed to enable effective implementation by both companies and government.

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10 IMF, *Tax Treatment of the Oil Sector* (2002).