HMRC - OT05205 - Scheme - The Scheme For Chargeable Periods On Or After 01 July 2006: Background

The legislation in question is contained within S61 and Sch 10 FA 1987 and SI 1987 no. 1338 as amended by SI 2006 no. 3089.

History

The nomination scheme was introduced by FA 1987 to address tax avoidance behaviour by oil producers called ‘tax-spinning’.

Tax Spinning

Tax-spinning was a feature of the 15-day Brent forward market, this became the 21-day Brent Forties Oseberg (BFO) forward market in 2002. The driver for the behaviour was the differential tax rates between production profits and trading profits. Originally this difference was mainly due to the fact that UK oil production profits were subject to PRT (on production from pre-1993 fields) whereas trading profits were not, although there were also instances where a company was not CT paying outside the ring-fence due to group relief etc. The introduction of the Supplementary Charge (SC) on production profits in 2002 (originally at 10% increased to 20% from 01 January 2006) meant that there was a differential tax rate between production and trading profits in all circumstances even where the production was derived from non-PRT post-1993 fields, this gave a further incentive to transfer value outside the ring-fence if possible.

To exploit these tax differences a company requires more sales contracts for delivery of a particular grade of oil in a month than the actual production to be delivered. This can only be achieved effectively where the contract can be booked out (i.e. cash settled) instead of being performed by the delivery of the oil under the contract. The sales contract must also be fungible i.e. any contract for the delivery month is interchangeable with any other.

In the case of the North Sea the only contract having these characteristics was the 15-day Brent forward contract and is now the BFO forward contract.

Tax-spinning is the purchasing and selling by the production company of many forward contracts for a month far more than is required to deliver its own production or satisfy its group refining and trading requirements.

A number of North Sea producers engaged in such activity for legitimate hedging purposes, but the turnover of such deals would be inflated by tax-spinning activity at certain times.

In any case where a company had a range of sales positions for a month it could then use hindsight to decide which sales contracts to deliver its oil through (the lowest priced ones) and book-out the rest against its purchased contracts.

Therefore the profit on the higher priced contracts was derived from trading activity and would be subject to the lower tax rate whereas the profit on the lower priced contracts was derived from their own higher taxed production.

The nomination scheme was designed to remove the element of hindsight from a company’s decision-making over which contract to deliver their oil through. It required the companies to nominate to LB Oil & Gas by 5pm on the second business day after the deal (shortened to one business day in 1993) which contract(s) they would be delivering their equity oil through for any month.

Researched by LBS Oil & Gas

Work undertaken by LBS Oil & Gas in 2005/06 established that the one-business-day time-limit for nominating, although hindering behaviour in some circumstances, had not stopped tax-spinning.

Revised Time Limit

This time-limit still gave the companies who chose to do so, the scope to assess the way the market was moving. If the market was continuing to fall after the company had entered the initial deal they would refrain from nominating that deal and open up a further purchase and a sales position for that month at the new lower price before the 5 PM time-limit for nominating the first deal. They would then book-out the first sale using the purchase contract leaving them one open sales position. The next day, if the market had gone up they would nominate this sale, if it had gone down they would again open up a sale and purchase position, book-out the previous day’s sale with the purchase contract leaving one open sales position. This pattern would continue until either prices started going up or they reached the latest date on which they could sell that particular delivery of oil. In this way the companies would capture the lowest price in the cycle for their production whilst ensuring all the higher prices were attributed to non-ring-fence trading.

This pattern of activity is

Furthermore, as the nomination scheme only applied to production from PRT fields, some companies would assign cargoes wholly to non-PRT paying fields (either post 1993 fields or non-PRT paying pre 1993 fields) and therefore have an unfettered ability to tax-spin to reduce the inside ring-fence profits.

This research precipitated the changes made to the Nomination Scheme in 2006.

Previous page

Next page