

Unofficial translation (13. March 2000) of

**Act of the Løgting (the Faroese Parliament)
on amendments to
the Hydrocarbon Tax Act
no. 26,
March 7, 2000**

1.

In the Act of Løgting no 26 of 21st April 1999 on Taxation of Revenue relating to Hydrocarbon Activities (Hydrocarbon Tax Act) these amendments shall be made:

(1) After part 2 the following will be entered as a new part:

"Part 2a

Assessment of special hydrocarbon income tax

10a.-(1) Special hydrocarbon income tax shall be assessed based on income from each hydrocarbon field individually.

(2) When a permit to explore for and produce hydrocarbons is extended with regard to production, the hydrocarbon accumulation is delimited by the Minister. Calculation of special tax on income from hydrocarbon production according to this Act shall be based upon this delimitation of the hydrocarbon accumulation.

(3) Revenue and expenditure are liable for special taxation from the day of approval of the field development plan for the hydrocarbon accumulation concerned. Where the approved field development plan involves a number of hydrocarbon accumulation to be exploited as one, the Minister is entitled to decide that these accumulation shall be considered as one hydrocarbon field as regards special taxation.

10b. Expenses incurred before the field development plan approval are not deductible. On the other hand, expenditure related directly to discovery and assessment of the hydrocarbon field(s) concerned is deductible. These expenses may be deducted in the year of field development plan approval. The Minister is entitled to make further provisions on what kinds of expenses are deductible.

10c.-(1) Expenditure from acquisition of production plants, rigs, ships, buildings and other installations, including pipelines and plant related thereto, as well as other equipment used in earning the revenue from a hydrocarbon field referred to in para 1) and 2) of section 4 (1) or in section 4 (2), shall be fully deducted within the year of acquisition.

(2) Expenditure relating to assets referred to in subsection (1) that are in progress by the end of the year at one's own expense may be deducted within the same year as they are incurred.

(3) Where a contract is made with a contractor on building/acquisition of the assets referred to in subsection (1), instalments of the acquisition expenditure may be deducted according to the provisions in the contract concerned. However, the amounts deducted may not exceed the amounts common in the industry sector, and the deduction shall not exceed the value of the work in progress at the time of payment of the instalments.

(4) Where assets, for which the acquisition expenditure is deductible, are partially used for other activities, the taxable deduction is calculated as the proportion of the value corresponding to the proportional use of the assets for activities mentioned in subsection 1.

(5) Where assets, for which the acquisition expenditure has been deducted according to the regulation laid down in subsections (1) to (4), are sold or used for other activities than those referred to in section 8, the proportional part of the sales revenue or market value that corresponds with use in connection with activities referred to in section 8, shall be included in the calculation of the special taxable income.

10d. Acquisition expenditure for licenses, permits or rights referred to in para. 3 of section 4(1) that are acquired after the field development plan approval shall be deducted within the year of acquisition.

10e.-(1) When the special taxable income is calculated, financial income and expenditure shall not be included.

(2) When the special taxable income is calculated, tax paid and assessed according to the regulation of part 2 shall be deducted. Where such paid tax relates to income from a number of hydrocarbon fields, the tax paid shall be divided between the fields in the same proportion as that in which they have contributed to the taxable income of which the tax paid is calculated.

(3) The Minister is entitled to make further provisions for the calculation referred to in subsection (2).

10f.-(1) The special tax is arranged in three tiers, the tiers being calculated individually according to the regulations in subsections (2) to (4).

(2) **First tier.** The special income from a hydrocarbon field is calculated on a yearly basis according to the regulations in sections 10a-e, the first time being in the year of the field development plan approval. Negative special income is then carried forward to the following year with a compounding of 20 per cent and is set off against positive special income from the following years. Special income calculated in this way is taxable with 10 per cent.

(3) **Second tier.** Special hydrocarbon income is calculated in the same way as in subsection (2). Negative special hydrocarbon income is carried forward to the following year with a compounding of 25 per cent and set off against positive special hydrocarbon income from the following years. Special hydrocarbon income calculated in this way is taxable with 15 per cent.

(4) **Third tier.** Special hydrocarbon income is calculated in the same way as in subsection (2). Negative special hydrocarbon income is carried forward to the following year with a compounding of 30 per cent and set off against positive special hydrocarbon income from the following years. Special hydrocarbon income calculated in this way is taxable with 15 per cent.

(5) Where more than 6 years pass from the year of the field development plan approval until commercial production of hydrocarbons from the hydrocarbon field referred to commences, negative special income from years that lie further back than 6 years back from the year when commercial production commences, shall be carried forward with a compounding no longer than the last 6 years before commercial production commences."

(2) 11-(3) shall be phrased as follows:

"Persons and companies, independent institutions, associations, etc. and estates of deceased persons with such income as referred to in section 4 (1) and (2) are, apart from the special tax referred to in part 2a, also liable to pay income tax to the treasury of such income with 27 per cent. The income tax for income referred to in section 4 (1) and (2) shall be calculated separately."

2.

This Act shall come into force on the day following its promulgation.

EXPLANATORY NOTES TO THE BILL

General notes

When the proposal for the Hydrocarbon Tax Act (Parliamentary file no. 79/1998) was submitted to the Parliament on 19 February 1999, the Executive said in their notes that a Hydrocarbon Taxation Act contributes to determining the total level of taxation on the activity of extracting and selling hydrocarbons, but that the establishment of the level of taxation necessarily must be considered in view of several other conditions, which at that point remained to be finally clarified.

It was said, too, that at a later time, but before the first licensing round – it would be decided whether it would also be necessary and possible to add a special tax to the existing system of tax legislation. It was pointed out that the decision whether or not to levy a special tax would be tied inseparably to the other requirements that will be imposed on oil companies when licenses are issued, such as possible royalty, requirements for carried participation by a state-owned oil company, operational obligations etc. The total financial burden of all the requirements was said to have to be compared to estimates of the prospectivity of the areas offered, and in that light, oil exploration off the Faroe Islands must be able to compete with the investment opportunities offered in other regions.

Finally, it was pointed out, that the total price for "the product", in other words, must be compared not only to its quality, but also to the price/quality of the "products" offered by other countries in the world that invite oil companies to engage in prospecting for oil.

Royalty

As stated in the general notes to The Faroese Parliament's file no. 17/1999: Proposal for first licensing round for exploration for and production of hydrocarbons, the Executive have decided to propose to the Parliament that demands on requirements for carried participation by a state-owned oil company not be put forward in this round. On the other hand, it is proposed to impose a production levy (royalty) of 2 per cent of the landed value of the produced hydrocarbons.

Normal hydrocarbon income tax

Tax levied on revenue according to section 4 (1) and (2) of the Hydrocarbon Tax Act, equals corporation tax (27 per cent at the moment). Were the corporation tax to be altered –increased or decreased – the normal hydrocarbon income tax would be altered correspondingly. The Executive stress their intentions that the Faroese oil tax regime be kept stable, and therefore propose that tax levied on income according to section 4 (1) and (2) of this Act be maintained on the same level as till now, that is 27 per cent.

When the taxable income is calculated according to the general tax legislation, fixed assets may be depreciated with up to 30 per cent of the balance a year. These depreciations are deducted from revenue. Expenditure for exploring and appraising shall be entered as expenditure in the same year as they are paid. An example of calculation of normal hydrocarbon income tax is shown below.

Table 1. Calculation of normal hydrocarbon income tax and royalty

Size of oilfield: 250 mmbbls	Revenue	Exploration & appraisal costs	Capital expenditure	Operating expenditure	Royalty	Depreciation balance	Depreciation of capital investment	Loss carried forward	Taxable income	Normal hydrocarbon income tax
Oil price: \$17/bbl										
(Mill. Kr.)										
2001	0,0	112,5	0,0	0,0	0,0	0,0	0,0	-112,5	-112,5	0,0
2002	0,0	173,0	0,0	0,0	0,0	0,0	0,0	-285,6	-285,6	0,0
2003	0,0	177,4	0,0	0,0	0,0	0,0	0,0	-462,9	-462,9	0,0
2004	0,0	0,0	218,2	0,0	0,0	218,2	0,0	-462,9	-462,9	0,0
2005	0,0	0,0	1.921,4	0,0	0,0	2.139,6	0,0	-462,9	-462,9	0,0
2006	0,0	0,0	2.886,2	0,0	0,0	5.025,8	0,0	-462,9	-462,9	0,0
2007	1.316,8	0,0	931,0	400,3	26,3	5.956,8	1.787,0	-1.359,7	-1.359,7	0,0
2008	4.319,3	0,0	526,2	642,1	86,4	4.696,0	1.408,8	0,0	822,2	222,0
2009	4.427,2	0,0	402,2	658,2	88,5	3.689,4	1.106,8	0,0	2.573,7	694,9
2010	4.254,3	0,0	318,6	674,7	85,1	2.901,2	870,4	0,0	2.624,2	708,5
2011	4.070,0	0,0	115,3	691,5	81,4	2.146,1	643,8	0,0	2.653,2	716,4
2012	3.933,3	0,0	0,0	708,8	78,7	1.502,3	450,7	0,0	2.695,2	727,7
2013	3.359,7	0,0	0,0	726,5	67,2	1.051,6	315,5	0,0	2.250,5	607,6
2014	3.130,6	0,0	0,0	744,7	62,6	736,1	220,8	0,0	2.102,5	567,7
2015	2.888,0	0,0	0,0	763,3	57,8	515,3	154,6	0,0	1.912,4	516,3
2016	2.170,8	0,0	0,0	782,4	43,4	360,7	108,2	0,0	1.236,8	333,9
2017	2.022,8	0,0	0,0	802,0	40,5	252,5	75,7	0,0	1.104,7	298,3
2018	1.727,8	0,0	0,0	822,0	34,6	176,7	53,0	0,0	818,2	220,9
2019	1.416,8	0,0	0,0	842,6	28,3	123,7	37,1	0,0	508,8	137,4
2020	1.234,4	0,0	0,0	863,6	24,7	86,6	26,0	0,0	320,1	86,4
2021	1.042,0	0,0	0,0	885,2	20,8	60,6	60,6	0,0	75,3	20,3
2022	0,0	0,0	2.117,1	0,0	0,0	2.117,1	0,0	0,0	0,0	-571,6 ¹⁾
	41.314,0	462,9	9.436,2	11.007,9	826,3	7.319,1	7.319,1	18.088,1	18.088,1	5.286,8

¹⁾ Regarding abandonment costs, it has not yet been decided how such expenses are to be handled. In this calculation example, a tax reimbursement is given towards abandonment costs.

With this proposal for amendments the Executive propose to levy a special income tax on hydrocarbon income in addition to the tax already levied on hydrocarbon income according to section 4 (1) and (2) of the Hydrocarbon Tax Act. The intention is to tax the part of the licensee's income that corresponds to the part of surplus that exceeds a certain internal rate of return of each individual oil field (IRR or ROR).

With this proposal the complete fiscal package has been determined. And as the terms for the first licensing round are laid down in Faroese Parliament's file no 17/1999, the Executive have at the same time taken into consideration the total level of taxation.

The special hydrocarbon income tax is an RRT (Resource Rent Tax), and is calculated of the net cash flow when the oil companies have reached a certain internal rate of return. Where an oil field does not render any particular amount of profit, the tax will not be calculated. However, the special

tax is progressive, so that if a company gets an even higher internal rate of return, it will be taxed on a higher level. The aim is thus to tax the resource rent¹ alone, see Figure 1 below.

The special income tax aims to levy a higher income tax on income deriving from hydrocarbon projects that are particularly profitable, which may therefore be looked upon as having a particularly high resource rent. The special income that is taxed by the higher rate of income taxation will in this way be assessed on each individual oil field, which is often referred to as ringfencing.

In the context of the first licensing round it is found likely that the market can cope with a system with the three kinds of levies and taxes, presently in force or in proposal: the low royalty of 2 per cent of the gross value, the normal hydrocarbon income tax of 27 per cent and the special hydrocarbon income tax in those cases where the profitability, measured by the internal rate of return, is particularly high. A government take of something above half the profits from a reasonably profitable oil field is found appropriate. The tax of the last "króna", - the marginal rate of tax – of these three kinds of tax altogether, calculated on a net basis, i.e. the royalty, is deductible in both kinds of income tax, and one of the kinds of income tax, the normal hydrocarbon income tax, is deductible in the other kind of income tax - the special tax - does not exceed 57,1 per cent with this proposal.

In the explanatory notes to the proposal of the Hydrocarbon Tax Act (Faroese Parliament's file no. 79/1998) it is mentioned that certain aspects of the existing general tax legislation may need to be amended, and also that the issue of tax treatment of the abandonment costs should be dealt with.

Concerning abandonment costs the Executive still find the need for abandonment tax rules not to be directly acute, even though the necessary rules should be put into place in good time before abandonment may occur. The Executive reflect on this issue, and still find that a possible solution in such cases could be allowing the taxpayer access to adjustment of the income tax return for a period of for example four years before the year of termination, providing access to carry back the abandonment costs.

A group has recently been given the task of solving other taxation problems, referred to in File no. 79/1998 of the Faroese Parliament, for example thin capitalisation, capital income tax related to termination of taxable activity (exit rules) etc.

Special income taxation

As mentioned above, the special tax aims to tax the income from individual hydrocarbon production fields, that are especially profitable, and which may therefore be looked upon as having a particularly high resource rent.

It is proposed that the special tax be progressive in three stages, so that where a hydrocarbon field has an internal rate of return higher than 20 per cent after charge of the normal hydrocarbon income tax, the special tax will be charged with 10 per cent. Where a hydrocarbon field renders a higher rate of return than 25 per cent or 30 per cent, respectively, after charge of the normal hydrocarbon income tax, the special income tax will be charged with 25 per cent or 40 per cent, respectively.

¹ Resource Rent is the amount of profit which exceeds the cost of the production factors, for example wages, general interest, etc. This is sometimes referred to as super-normal profit.

The calculation of the special taxable income is done by a so-called net cash flow calculation for each oil field individually, which means that the expenses are deductible the same year as they are incurred. The general definition of expenditure of the tax legislation is retained, while investments – which are usually activated and depreciated over a certain number of years - as a main rule, may be entered as expenditure when they are incurred.

The theoretical basis for the special income tax is that the taxpayer does not have to pay this extra income tax until he has had a certain internal rate of return of the individual oil field. This means that the negative cash flow during the first years (exploration and investment in production plants, etc.) is given the possibility to be paid back with a certain minimum interest, before the tax is charged. The special tax is not calculated until the internal rate of return exceeds a certain minimum interest, a threshold.

The minimum interest, or threshold, will be fixed according to experts' opinion of what oil companies demand, under the present circumstances, as minimum level of return, in order to proceed with exploration in areas like the Faroe Islands. Apart from the market loan interest (which also reflects the expected future inflation), the exploration risk (that is the uncertainty whether oil in profitable amounts is to be found within the area) is considered, and furthermore the cost of producing oil or gas in deep waters and tough weather conditions is considered. Considering the circumstances above, the lowest threshold will be fixed according to an internal rate of return of 20 per cent after the charge of the normal hydrocarbon tax. After that, the tax level is increased in two stages in accordance with the oil field becoming more and more profitable, that is when a threshold is passed corresponding to an internal rate of return of 25 per cent and 30 per cent, respectively.

In fact, the expenditure is deducted the same year as it incurs. Expenditure from interest is not deductible; but then again a compounding will be made corresponding to more than the usual market interest. This counterbalances expenditure from interest as well as a general return.

Such compounding is done for separate hydrocarbon fields, providing the yearly taxable income shows a deficit after including deficit and compounding from previous years. In other words, a compounding will be done, providing the taxpayer's net cash flow (compounding included) has not yet become positive.

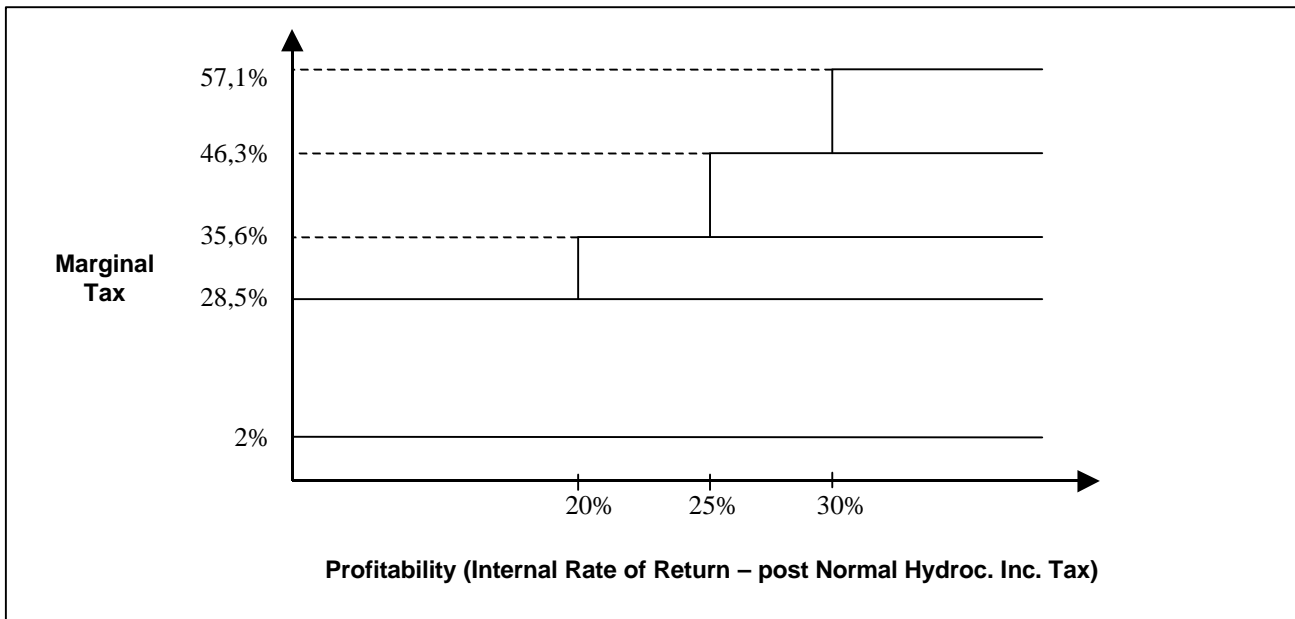
When the special taxable income has thus become positive, it will be taxed by a three-tier-system, as explained above.

Royalty and normal hydrocarbon income tax that have been paid and which concern the part of the taxable income that comes from the oil field in question are deductible in the calculation of the income liable to special hydrocarbon income tax.

When the paid royalty (2 per cent) and normal hydrocarbon income tax (27 per cent) have been deducted in the calculation of the special tax, the marginal tax equals 35,6 per cent, when first tier of the special tax applies. Where first tier as well as second tier of the special tax applies, the marginal tax is 46,3 per cent, and where third tier of the special tax is paid the marginal tax is 57,1 per cent. Figure 1 below shows the total tax package. The tables 3, 4 and 5 show a calculation example of special income tax at first, second and third tier, respectively.

As the basis for charging the special tax is calculated for each oil field individually, it will also be necessary to calculate income as well as expenditure for each oil field individually. In this connection it will be necessary to put in place further rules on how to allocate the (income and) expenditure that does not come directly from one separate oil field, to the individual oil fields. This applies to paid tax, too, providing the taxable income comes from production on a number of oil fields.

Figure 1. Marginal tax in proportion to profitability



When taxing an income, one of the most important matters is whether the tax liability itself influences the companies' behaviour in such a way that they for tax reasons only, take measures that they would not have done, had the tax not been there. There is a risk that a high marginal tax together with the possibility to deduct expenses, together, may encourage the oil companies to be extravagant. This phenomenon is often referred to as "gold plating". This becomes a considerable risk with the kind of tax referred to here, as the expenditure is given a yearly compounding of 20-30 per cent before it is deducted in the tax calculation, until the tax payer reaches the special taxation level. According to experts, this risk should, however, not be overestimated. When decisions on the largest expenditure are at hand, that is when the oil field is developed, the oil companies have no possibility of knowing for sure whether they will ever get a profit large enough to reach the level of special taxation. This encourages the oil companies to care about their investment costs. The high level of the thresholds is in fact a result of this uncertainty that applies to both oil companies and authorities. Furthermore, the field development plans have to be approved by the authorities, who also take into consideration how different development possibilities of the oil field influence the Faroese society's income, including the tax revenue. Later, when the profit from an oil field has reached a higher level, so that the company has begun paying special hydrocarbon income tax, the expenditure is no longer carried forward with a compounding. At this point it may be tempting for the oil companies to enter new investments into an oil field already explored, so that the net cash flow will again be negative for a period of time, but these investments, too, require an approval from the authorities, who will of course be careful to approve any investment that does not seem to be economically sound.

The example below shows an oil field of 250 mmbbls. The cost and production profiles are constructed similar to profiles from oil fields in the neighbouring countries. It should be mentioned that the size of the oil field Foinaven, situated on the British side of the median line, close to Faroese waters, is 250 mmbbls.

Table 2. Calculation w/ model field of 250 mmbbls at \$17 / bbl

Size of oilfield: 250 mmbbls								
Oil price: \$17/bbl								
(Mill. Kr.)	Revenue	Exploration, appraisal and capital expenditure	Operating expenditure	Royalty	Normal hydrocarbon income tax	Special hydrocarbon income tax	Net cash flow to oil company	Government take
2001	0,0	112,5	0,0	0,0	0,0	0,0	-112,5	0,0
2002	0,0	173,0	0,0	0,0	0,0	0,0	-173,0	0,0
2003	0,0	177,4	0,0	0,0	0,0	0,0	-177,4	0,0
2004	0,0	218,2	0,0	0,0	0,0	0,0	-218,2	0,0
2005	0,0	1.921,4	0,0	0,0	0,0	0,0	-1.921,4	0,0
2006	0,0	2.886,2	0,0	0,0	0,0	0,0	-2.886,2	0,0
2007	1.316,8	931,0	400,3	26,3	0,0	0,0	-40,8	26,3
2008	4.319,3	526,2	642,1	86,4	222,0	0,0	2.842,5	308,4
2009	4.427,2	402,2	658,2	88,5	694,9	0,0	2.583,4	783,4
2010	4.254,3	318,6	674,7	85,1	708,5	0,0	2.467,4	793,6
2011	4.070,0	115,3	691,5	81,4	716,4	0,0	2.465,4	797,8
2012	3.933,3	0,0	708,8	78,7	727,7	75,5	2.342,6	881,9
2013	3.359,7	0,0	726,5	67,2	607,6	195,8	1.762,5	870,7
2014	3.130,6	0,0	744,7	62,6	567,7	175,6	1.580,1	805,9
2015	2.888,0	0,0	763,3	57,8	516,3	292,4	1.258,2	866,5
2016	2.170,8	0,0	782,4	43,4	333,9	252,8	758,3	630,1
2017	2.022,8	0,0	802,0	40,5	298,3	220,5	661,6	559,3
2018	1.727,8	0,0	822,0	34,6	220,9	162,6	487,8	418,1
2019	1.416,8	0,0	842,6	28,3	137,4	102,1	306,4	267,9
2020	1.234,4	0,0	863,6	24,7	86,4	64,9	194,7	176,0
2021	1.042,0	0,0	885,2	20,8	20,3	28,9	86,7	70,1
2022	0,0	2.117,1	0,0	0,0	-571,6 ¹⁾	-529,3 ¹⁾	-1.016,2 ¹⁾	-1.100,9 ¹⁾
	41.314,0	9.899,2	11.007,9	826,3	5.286,8	1.041,8	13.252,0	7.154,9

¹⁾ Regarding abandonment costs, it has not yet been decided how such expenses are to be handled. In this calculation example, a tax reimbursement is given towards abandonment costs.

Table 3. Calculation w/ model field of 250 mmbbls at \$25 / bbl

Size of oilfield: 250 mmbbls								
Oil price: \$17/bbl								
(Mill. Kr.)	Revenue	Exploration, appraisal and capital expenditure	Operating expenditure	Royalty	Normal hydrocarbon income tax	Special hydrocarbon income tax	Net cash flow to oil company	Government take
2001	0,0	112,5	0,0	0,0	0,0	0,0	-112,5	0,0
2002	0,0	173,0	0,0	0,0	0,0	0,0	-173,0	0,0
2003	0,0	177,4	0,0	0,0	0,0	0,0	-177,4	0,0
2004	0,0	218,2	0,0	0,0	0,0	0,0	-218,2	0,0
2005	0,0	1.921,4	0,0	0,0	0,0	0,0	-1.921,4	0,0
2006	0,0	2.886,2	0,0	0,0	0,0	0,0	-2.886,2	0,0
2007	1.936,5	931,0	400,3	38,7	0,0	0,0	566,5	38,7
2008	6.351,9	526,2	642,1	127,0	923,8	0,0	4.132,7	1.050,8
2009	6.510,7	402,2	658,2	130,2	1.246,2	0,0	4.073,8	1.376,4
2010	6.256,3	318,6	674,7	125,1	1.238,3	449,0	3.450,7	1.812,4
2011	5.985,2	115,3	691,5	119,7	1.223,1	1.161,6	2.674,0	2.504,5
2012	5.784,3	0,0	708,8	115,7	1.217,5	1.496,9	2.245,4	2.830,1
2013	4.940,8	0,0	726,5	98,8	1.026,0	1.235,8	1.853,7	2.360,6
2014	4.603,9	0,0	744,7	92,1	957,5	1.123,8	1.685,8	2.173,4
2015	4.247,1	0,0	763,3	84,9	875,9	1.009,2	1.513,7	1.970,0
2016	3.192,4	0,0	782,4	63,8	604,2	696,8	1.045,1	1.364,9
2017	2.974,7	0,0	802,0	59,5	550,1	625,3	937,9	1.234,9
2018	2.540,9	0,0	822,0	50,8	436,1	492,8	739,2	979,7
2019	2.083,5	0,0	842,6	41,7	313,8	354,2	531,3	709,7
2020	1.815,3	0,0	863,6	36,3	240,1	270,1	405,1	546,5
2021	1.532,3	0,0	885,2	30,6	150,1	186,6	279,8	367,3
2022	0,0	2.117,1	0,0	0,0	-571,6 ¹⁾	-846,8 ¹⁾	-698,6 ¹⁾	-1.418,5 ¹⁾
	60.755,8	9.899,2	11.007,9	1.215,1	10.431,1	8.255,2	19.947,4	19.901,4

¹⁾ Regarding abandonment costs, it has not yet been decided how such expenses are to be handled. In this calculation example, a tax reimbursement is given towards abandonment costs.

The numbers in table 2 show that the total amount of profits to the treasury from such an oil field, with the given conditions, would be 35 per cent, while the oil company would retain 65 per cent. Nevertheless, it is probably more correct to regard the net present value of these cash flows instead. If the net cash flow is discounted with 10%, the Treasury receives 43% of the discounted profits in table 2. Similarly, the treasury receives 53% of the discounted profits if the price is \$25/bbl. A calculation based upon that oil price is shown in table 3 above. The net present value of these possible tax revenues and its division upon tax types is as shown below.

(m.kr.)	\$17 / bbl	\$25 / bbl
Royalty	259,9	382,2
Normal Hydrocarbon Income Tax	1.725,1	3.334,4
Special Hydrocarbon Income Tax	280,2	2.275,0
	2.265,2 (43%)	5.991,6 (53%)

Table 4. Calculation of special hydrocarbon income tax (1. tier)

Size of oilfield: 250 mmbbls	Net cash flow to oil company after normal hydrocarbon income tax	Expenditure from previous years	Balance carried forward	Special hydrocarbon income before compounding	Compounding (20%)	Year-end special hydrocarbon income	Special hydrocarbon income tax - 1. tier (10%)
Oil price: \$17/bbl							
(Mill. Kr.)							
2001	-112,5	0,0	0,0	0,0	0,0	0,0	0,0
2002	-173,0	-112,5	0,0	0,0	0,0	0,0	0,0
2003	-177,4	-285,6	0,0	0,0	0,0	0,0	0,0
2004	-218,2	-462,9	0,0	-681,1	-136,2 ¹⁾	-817,3	0,0
2005	-1.921,4	0,0	-817,3	-2.738,7	-547,7	-3.286,5	0,0
2006	-2.886,2	0,0	-3.286,5	-6.172,7	-1.234,5	-7.407,3	0,0
2007	-40,8	0,0	-7.407,3	-7.448,0	-1.489,6	-8.937,6	0,0
2008	2.842,5	0,0	-8.937,6	-6.095,1	-1.219,0	-7.314,1	0,0
2009	2.583,4	0,0	-7.314,1	-4.730,7	-946,1	-5.676,9	0,0
2010	2.467,4	0,0	-5.676,9	-3.209,5	-641,9	-3.851,3	0,0
2011	2.465,4	0,0	-3.851,3	-1.385,9	-277,2	-1.663,1	0,0
2012	2.418,1	0,0	-1.663,1	755,0	0,0	755,0	75,5
2013	1.958,3	0,0	0,0	1.958,3	0,0	1.958,3	195,8
2014	1.755,7	0,0	0,0	1.755,7	0,0	1.755,7	175,6
2015	1.550,6	0,0	0,0	1.550,6	0,0	1.550,6	155,1
2016	1.011,1	0,0	0,0	1.011,1	0,0	1.011,1	101,1
2017	882,1	0,0	0,0	882,1	0,0	882,1	88,2
2018	650,3	0,0	0,0	650,3	0,0	650,3	65,0
2019	408,5	0,0	0,0	408,5	0,0	408,5	40,9
2020	259,7	0,0	0,0	259,7	0,0	259,7	26,0
2021	115,6	0,0	0,0	115,6	0,0	115,6	11,6
2022	-2.117,1	0,0	0,0	-2.117,1	0,0	-2.117,1	-211,7 ²⁾
	13.722,3				-6.492,4		723,0

Production plan approved

¹⁾ Compounding is calculated the first time the year that the production plan is approved. The compounding is calculated as 20% of the special hydrocarbon income before compounding, e.g. 20% of -681,1 = -136,2.

²⁾ Regarding abandonment costs, it has not yet been decided how such expenses are to be handled. In this calculation example, a tax reimbursement is given towards abandonment costs.

As the table shows, the first tier of the special tax system does not apply until the total taxable amount, post-20% compounding, is positive. This means that the company has reached a rate of internal return of 20 per cent before the first tier of special tax (10 per cent) applies.

Table 5. Calculation of special hydrocarbon income tax (2. tier)

Size of oilfield: 250 mmbbls	Net cash flow to oil company after normal hydrocarbon income tax	Expenditure from previous years	Balance carried forward	Special hydrocarbon income before compounding	Compounding (25%)	Year-end special hydrocarbon income	Special hydrocarbon income tax - 2. tier (15%)
Oil price: \$17/bbl							
(Mill. Kr.)							
2001	-112,5	0,0	0,0	0,0	0,0	0,0	0,0
2002	-173,0	-112,5	0,0	0,0	0,0	0,0	0,0
2003	-177,4	-285,6	0,0	0,0	0,0	0,0	0,0
2004	-218,2	-462,9	0,0	-681,1	-170,3	-851,4	0,0
2005	-1.921,4	0,0	-851,4	-2.772,8	-693,2	-3.466,0	0,0
2006	-2.886,2	0,0	-3.466,0	-6.352,2	-1.588,1	-7.940,3	0,0
2007	-40,8	0,0	-7.940,3	-7.981,0	-1.995,3	-9.976,3	0,0
2008	2.842,5	0,0	-9.976,3	-7.133,8	-1.783,4	-8.917,2	0,0
2009	2.583,4	0,0	-8.917,2	-6.333,8	-1.583,5	-7.917,3	0,0
2010	2.467,4	0,0	-7.917,3	-5.449,9	-1.362,5	-6.812,3	0,0
2011	2.465,4	0,0	-6.812,3	-4.346,9	-1.086,7	-5.433,6	0,0
2012	2.418,1	0,0	-5.433,6	-3.015,5	-753,9	-3.769,4	0,0
2013	1.958,3	0,0	-3.769,4	-1.811,0	-452,8	-2.263,8	0,0
2014	1.755,7	0,0	-2.263,8	-508,1	-127,0	-635,1	0,0
2015	1.550,6	0,0	-635,1	915,5	0,0	915,5	137,3
2016	1.011,1	0,0	0,0	1.011,1	0,0	1.011,1	151,7
2017	882,1	0,0	0,0	882,1	0,0	882,1	132,3
2018	650,3	0,0	0,0	650,3	0,0	650,3	97,6
2019	408,5	0,0	0,0	408,5	0,0	408,5	61,3
2020	259,7	0,0	0,0	259,7	0,0	259,7	38,9
2021	115,6	0,0	0,0	115,6	0,0	115,6	17,3
2022	-2.117,1	0,0	0,0	-2.117,1	0,0	-2.117,1	-317,6 ¹⁾
	13.722,3				-11.596,5		318,9

Production plan approved

¹⁾ Regarding abandonment costs, it has not yet been decided how such expenses are to be handled. In this calculation example, a tax reimbursement is given towards abandonment costs.

As the table shows, the rate of internal return from this oil field is above 25 per cent, because the second tier of special taxation (15 per cent) is activated. These 15 per cent are to be calculated on top of the 10 per cent in the first tier of the special tax, so that special tax paid is actually 25 per cent.

The calculation of third tier is carried out in the same way, with an additional 30 per cent added to the negative balance, and an increased tax pressure of 15 per cent. Thus, if the rate of internal return of an oil field is higher than 30 per cent, the special taxation is 40 per cent.

As the table below shows, third tier of special taxation does not apply to the oil field in the example. This is a result of the fact that the rate of internal return of this oil field is under 30 per cent. This can be seen by the compounding being higher than the net cash flow.

Table 6. Calculation of special hydrocarbon income tax (3. tier)

Size of oilfield: 250 mmbbls	Oil price: \$17/bbl	(Mill. Kr.)	Net cash flow to oil company after normal hydrocarbon income tax	Expenditure from previous years	Balance carried forward	Special hydrocarbon income before compounding	Compounding (30%)	Year-end special hydrocarbon income	Special hydrocarbon income tax - 1. tier (15%)
2001	-112,5	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
2002	-173,0	-112,5	0,0	0,0	0,0	0,0	0,0	0,0	0,0
2003	-177,4	-285,6	0,0	0,0	0,0	0,0	0,0	0,0	0,0
2004	-218,2	-462,9	0,0	-681,1	-204,3	-885,4	0,0	0,0	0,0
2005	-1.921,4	0,0	-885,4	-2.806,8	-842,1	-3.648,9	0,0	0,0	0,0
2006	-2.886,2	0,0	-3.648,9	-6.535,1	-1.960,5	-8.495,7	0,0	0,0	0,0
2007	-40,8	0,0	-8.495,7	-8.536,4	-2.560,9	-11.097,4	0,0	0,0	0,0
2008	2.842,5	0,0	-11.097,4	-8.254,8	-2.476,5	-10.731,3	0,0	0,0	0,0
2009	2.583,4	0,0	-10.731,3	-8.147,9	-2.444,4	-10.592,3	0,0	0,0	0,0
2010	2.467,4	0,0	-10.592,3	-8.124,9	-2.437,5	-10.562,3	0,0	0,0	0,0
2011	2.465,4	0,0	-10.562,3	-8.096,9	-2.429,1	-10.526,0	0,0	0,0	0,0
2012	2.418,1	0,0	-10.526,0	-8.107,8	-2.432,3	-10.540,2	0,0	0,0	0,0
2013	1.958,3	0,0	-10.540,2	-8.581,8	-2.574,5	-11.156,4	0,0	0,0	0,0
2014	1.755,7	0,0	-11.156,4	-9.400,7	-2.820,2	-12.220,9	0,0	0,0	0,0
2015	1.550,6	0,0	-12.220,9	-10.670,3	-3.201,1	-13.871,4	0,0	0,0	0,0
2016	1.011,1	0,0	-13.871,4	-12.860,3	-3.858,1	-16.718,4	0,0	0,0	0,0
2017	882,1	0,0	-16.718,4	-15.836,3	-4.750,9	-20.587,1	0,0	0,0	0,0
2018	650,3	0,0	-20.587,1	-19.936,8	-5.981,0	-25.917,8	0,0	0,0	0,0
2019	408,5	0,0	-25.917,8	-25.509,3	-7.652,8	-33.162,1	0,0	0,0	0,0
2020	259,7	0,0	-33.162,1	-32.902,4	-9.870,7	-42.773,1	0,0	0,0	0,0
2021	115,6	0,0	-42.773,1	-42.657,5	-12.797,3	-55.454,8	0,0	0,0	0,0
2022	-2.117,1	0,0	-55.454,8	-57.571,9	-17.271,6	-74.843,5	0,0	0,0	0,0
	13.722,3						-88.565,7		0,0

Production plan approved

Administrative and budgetary consequences

This proposal is not expected to have any administrative or budgetary consequences the first few years. As the tables 2 and 3 show, the special tax *may* have a great influence on the treasury revenue. On the other hand, the tables also show, that no revenue can be expected from special income tax, until the normal hydrocarbon income tax has been paid over a period.

Comments on the particular amendments

Re. Amendment 1

Section 10 a

Special hydrocarbon income tax shall be assessed based on income from each hydrocarbon field individually. One or several hydrocarbon discoveries may be exploited as one, and therefore operationally and economically treated as one unit. According to section 1 of the standard license for first licensing round a hydrocarbon discovery is "one contiguous accumulation of hydrocarbons

in the subsoil. In case of doubt, the Minister of Petroleum shall determine what constitutes a hydrocarbon deposit".

The discovery is delimited geologically and geographically when the Minister of Petroleum according to section 8 2) of the Hydrocarbon Activities Act extends the exploration and production license with regard to production. The Minister may make it a condition for extending the license that the licensee files an application for approval of the field development plan within a set time limit. The existence of a hydrocarbon field economically and in tax context is according to this Act considered to begin when the Minister of Petroleum approves a field development plan for the hydrocarbon field. The main rule is therefore, that only income and expenditure paid after this approval are included when the special hydrocarbon income tax is calculated. Nevertheless, section 10b provides the possibility of deducting certain expenditure related to exploration and appraisal of the hydrocarbon discovery(ies) in question.

Now and then, a field development plan includes exploitation of a number of hydrocarbon discoveries as one. In these cases technological and economical considerations may favour the fields exploited as one to be handled as one unit for tax purposes. In matters of dispute the Minister of Petroleum decides, after consulting the Minister of Tax Affairs, whether the fields exploited as one shall be considered as one unit.

Section 10 b

When the calculation of special hydrocarbon income tax of a hydrocarbon field is made, expenditure paid before the hydrocarbon field approval may not be deducted. On the other hand, expenditure with direct connection to discovery and appraisal of the hydrocarbon field shall be deductible in the year of field development plan approval. According to the Hydrocarbon Activities Act expenditure for development purposes is usually not incurred until after the approval of the field development plan.

Expenditure from buying information on seismic results etc. before the discovery was made, charges for pre-exploration licences, application costs and area fees are examples of non-deductible expenditure. Expenditure from the drilling that lead to the discovery of the actual hydrocarbon field and subsequent appraisal, etc. can be mentioned as examples of deductible expenditure.

If the need should arise, the Minister is entitled to make further provisions on which types of expenditure are deductible in a statutory instrument.

Section 10 c

The calculation of special hydrocarbon income differs from the general tax regulation, as expenditure from the acquisition of assets is fully deductible in the acquisition year. The legal conditions relating to transfer of property rights are the same for access to deduct acquisition expenditure in the acquisition year as the conditions applying to access to depreciation of assets, for example conditions of delivery and the asset being ready for use.

Prior to an offshore hydrocarbon production it is necessary for the oil companies to acquire different kinds of assets. Furthermore, there is the need for production facilities that will be in use for a number of years. According to the present legislation on tax depreciation, this kind of large

development on one's own account may not be depreciated until the facilities can be put into use. This section proposes, however, that expenditure paid for facilities to be used in connection with the earning of income according to para. (1) and (2) of section 4 1) and section 4 2) from a hydrocarbon field is deductible in the calculation of special hydrocarbon income the same year as it is paid.

Even though it is unusual for the time of actual payment to influence when to include an expense in the calculation of the special hydrocarbon income, this section proposes that deduction of instalments of expenditure from building/acquisition of facilities to be used in gaining the normal hydrocarbon income according to para. (1) and (2) of section 4 1) and section 4 2) be allowed, where such a contract is made with a building contractor. In such cases deduction shall be allowed, according to the rules in the actual contract, but not for larger amounts than what is common for the industry sector in question. Nevertheless, the deduction must not exceed the acquisition expenditure for the part of the whole contract that has been delivered and activated in the contractor's accounts, when an instalment is paid.

Proportional use of assets for gaining income as referred to in para. (1) and (2) of section 4 1) and section 4 2) allows proportional deduction of the acquisition expenditure according to the use referred to in para. (1) and (2) of section 4 1) and section 4 2).

Section 10d

The calculation of special hydrocarbon income differs from the general tax regulation as acquisition expenditure for assets can be fully deducted in the acquisition year. According to section 9 acquisition expenditure spent on licences, permits and rights, mentioned in para. 3 of section 4 1) can be depreciated with equally large sums over 5 years. But when the special hydrocarbon income is calculated, expenditure from acquisition of licenses etc. before the approval of the involved field development plan is of no relevance. Where such licences etc. have been acquired after the approval of the involved field development plan the acquisition expenditure can be deducted the same year as the acquisition takes place.

Section 10e

The calculation of the special hydrocarbon income differs from the general regulation on calculation of taxable income as financial income and expenditure may not be included in the calculation of the special hydrocarbon income.

The cause of this is that the special hydrocarbon income tax is calculated according to the economic return on the investment in a hydrocarbon field. And this return is to be calculated independently of the distribution of the investment financing between equity and external financing. Instead of allowing deduction for financial expenditure, a yearly compounding of the taxable deficit is allowed until the income from the hydrocarbon field has returned the investments made with a compounding that among other things includes a compensation for financial expenditure.

The aim is that a hydrocarbon field should not be liable to special hydrocarbon income tax before it has become profitable to the extent where the rate of internal return after normal hydrocarbon income tax exceeds 20%. Therefore, paid normal hydrocarbon income tax (corporation tax) shall be deducted when special hydrocarbon income tax is calculated. But as the normal hydrocarbon income tax is not calculated for each hydrocarbon field individually, it is necessary to allocate the

normal hydrocarbon income tax to all the hydrocarbon fields involved, if the taxpayer runs activities on a number of hydrocarbon fields according to the permit referred to in the Hydrocarbon Activities Act.

The distribution between the individual hydrocarbon fields shall match the proportion with which the individual profitable hydrocarbon fields have contributed to the taxable income of which the normal hydrocarbon income tax is calculated.

Where the need should arise for more specific rules on how to calculate the mentioned distribution the Minister can make such provisions in a statutory instrument.

Section 10f

The special hydrocarbon income tax is based on a progressive system, arranged in three tiers, so that where a hydrocarbon field yields a return of over 20% after the normal hydrocarbon income tax being calculated, the special hydrocarbon income tax is set at 10%. Where a hydrocarbon field has a return of more than 25% or 30%, respectively, after calculation of the normal hydrocarbon income tax, the special hydrocarbon income tax is fixed at 25% or 40%, respectively. The tax is in this way calculated in three cumulative tiers.

Where a royalty of 2% and a normal hydrocarbon income tax of 27% have been deducted in the calculation of the special hydrocarbon income tax, the marginal tax will be 35,6% if special tax is paid on first tier. Where special hydrocarbon tax is paid on both first and second tier, the marginal tax would be 46,3%, and where special hydrocarbon income tax is paid on third tier, the marginal tax would be 57,1%.

When an oil field is developed the special hydrocarbon income will be negative during the first years of income. The negative balance shall be calculated each year individually, and until it is set off against a positive balance, it is given a yearly compounding of respectively 20%, 25% or 30%. The compounding shall be calculated each year of the balance carried forward.

Where too long time passes from the commencement of the development of an oil field until production begins, the mentioned compounding may raise the expenditure, and tempt to extravagance, referred to as gold plating, compare to the passage on this in the general notes. In order to limit this problem it is laid down in subsection 5 that negative special hydrocarbon income from a certain year at most can be carried forward with a compounding for 6 years, before commercial production commences. Where more than 6 years pass before such production commences the deficit from the years that lie further back than 6 years shall be carried forward without the compounding until the year that was 6 years before the year when such production commences. Then this shall be the year when the compounding starts rather than the year of the field development plan approval. If everything goes according to plan, one must, however, consider it an exception that more than 6 years should pass from the year of the field development plan approval to the production commences. Commercial production means that the year's income from the oil production from the hydrocarbon field involved is larger than the operating cost from the field, as these are calculated in the accounts of the normal hydrocarbon income tax.

Re Amendment 2

The subject is to alter section 11 3) so that both physical and judicial persons pay the same percentage rate of tax of normal hydrocarbon income as referred to in section 4 1) and 2), and that the percentage stays at 27, even if the tax percentage should be altered for Faroese companies that do not have any hydrocarbon income referred to in section 4 1) and 2). At the same time it is confirmed in this section that all those that have an income referred to in section 4 1) and 2) are liable to special hydrocarbon income tax as laid down in Part 2 a.