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The Norwegian tax rules on reimbursement for exploration costs

The Norwegian tax rules on reimbursement for exploration costs are a hot topic these days. EFTAs Surveillance Authority (ESA) is currently considering whether or not to open a formal investigation of the rules because they might involve illegal state aid. In today's news letter, our lawyers explain the relevant issues that ESA needs to consider and our opinion on these.

In the summer of 2017, Bellona sent a complaint to ESA regarding the Norwegian rules for reimbursement of investment costs, claiming that these rules constitute illegal state aid. This has led to an extensive process involving exchange of letters and meetings between the Norwegian Ministry of Finance and ESA.

The Ministry of Finance has submitted a description of the petroleum tax system in general, the relevant rules on reimbursement and their assessment of whether these involve state aid. They have also provided comprehensive answers to a number of follow-up questions from ESA. Now ESA must decide whether to open a formal investigation or to reject the complaint from Bellona. If ESA opens a formal investigation, this does not mean that ESA has concluded that the measure involves state aid, but that the scheme will be subject to a thorough investigation by ESA.

Costs for explorations activities (e.g. acquisition of seismic equipment or drilling of exploration wells) are subject to tax deductions for the company carrying these costs. A company with fields in production and an income from petroleum activities
is be able to deduct the exploration costs immediately and reduce the taxable net profit in the income year. Thus, these companies receive an indirect payment of the tax value from the Norwegian State.

A company with no, or low, income from petroleum activity, will not have any, or limited, effect of a tax deduction for exploration costs in the income year in which the exploration costs occur. However, the exploration costs may be carried forward with interest in order to maintain the full value of the tax deductions.

Pursuant to the Norwegian Petroleum Tax Act § 3 c) (5), companies recording a loss, can receive an annual reimbursement of the tax value of exploration costs instead of carrying the exploration costs forward with interest. This is the scheme which Bellona argues involves illegal state aid. ESA has in addition to this, raised the question whether allowing loss carry forward with interest also may involve state aid.

The scheme was introduced in 2005. This was partly in order to reduce the barrier for participation in petroleum activity on the Norwegian continental shelf, and to contribute to socio-economic use of the petroleum resources. Furthermore, this led to companies not in a tax-paying position (typically, small companies) being treated equally as companies in a taxpaying position (typically established, large companies with fields in production.) Before this rule was introduced, companies not in a tax-paying position, who were carrying forward losses, had a significant liquidity disadvantage compared to companies in a taxpaying position with corresponding exploration costs. The main purpose of the scheme was thus to correct a lack of neutrality in the petroleum tax system.

The reimbursement for exploration costs provides all companies with exploration costs with an opportunity to have these costs refunded at the same time (in the year the costs are incurred) and with the same tax value (78%).

For a measure to constitute state aid, it needs to have all these features:

- aid is granted by the state or through state resources
- to a certain undertaking
- thereby creating a selective advantage
- the transfer of resources distorts or has the potential to distort competition and trade between EEA countries.

The relevant features to assess in this case are whether the scheme confers an advantage on the companies receiving the reimbursement and whether this is selective advantage.

Norwegian authorities claim that the scheme does not confer an advantage on the relevant companies that they would not receive under normal market conditions. It is the effect of the measure that is decisive, not the intent. The Norwegian authorities point out that the scheme merely provides for neutral petroleum taxation. Furthermore, the scheme does not affect the value of the deduction, or the Norwegian state's risk in exploration activities, it simply makes sure that the same tax value is refunded at the same point in time for all companies. Consequently, the scheme cannot involve an advantage.

If ESA was to conclude that the scheme does involve an advantage, ESA must also consider whether this advantage is selective. The advantage must favour *"certain undertakings or the production of certain goods."* According to case law, when assessing whether an exemption from tax rule is selective, one must use a three-step analysis. First, the system of reference must be established. Second, it should be determined whether a given measure constitutes a derogation from that system of reference insofar as it differentiates between economic operators who are in a comparable factual and legal situation. Finally, it needs to be established whether the derogation is justified by the nature and logic of the system, in which case it is not selective.

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Bellona claims that the three-step-analysis is not applicable in this situation because the reimbursement has the form of a subsidy and not a tax advantage.The Ministry of Finance rejects this standpoint and claims that the scheme is an integral part of the petroleum tax regime and a tax element. In our opinion it is reasonably clear that this is a tax advantage and not a direct subsidy and that the three-step analysis must be applied.

Bellona further claims that if the three-step analysis shall be applied, the system for reimbursement of exploration costs must be regarded as an exemption and that this is inconsistent with the nature and logic of the system. Norwegian authorities argue that the scheme cannot be regarded as an exemption, and that it is only a matter of equal treatment, and a necessary measure in order to achieve neutral taxation. The reimbursement rules do not treat companies in comparable legal and factual circumstances differently. If ESA nevertheless

concludes that this must be deemed to be and exaptation, the Ministry of Finance is of the opinion that this must be regarded as consistent with the logic of the system.

It is of paramount importance that ESA in its assessment establishes the correct system of reference, which in our opinion is the Norwegian petroleum tax system. Furthermore, it is crucial that ESA has a very good understanding of this system. The Member States are free to create their own tax policies and legislation, which is something that cannot be reviewed by ESA. ESA's assessment is limited to the question of whether exemptions are incoherent with the logic of the system. In order to perform such an assessment one must have comprehensive knowledge of the system itself, the structure of the system and its inherent logic and purpose. We think that the public debate on this topic in recent time has been influenced too much by fairly narrow state aid assessments, lacking the sufficient understanding of the Norwegian petroleum tax system.

Furthermore, it is in our opinion important that ESA in their assessment of whether the scheme differentiates between companies in comparable legal av factual situations, do just that: compare companies in comparable legal and factual situations. This demands in-depth knowledge of the petroleum industry. In our view, there are no other companies in a comparable factual and legal situation, and therefore difficult to establish such differentiation. It is also difficult to defend, based on the logic of the system, that the companies' possibility to use the right to deduct exploration costs, should depend on whether they are in a taxpaying position or not.

This is a complex legal assessment, and it is not obvious how ESA will conclude. Nevertheless, we find it difficult see that the rules on reimbursement of exploration costs constitutes state aid. If ESA should find that it does, it is our opinion that the aid element is limited to the possible advantages the companies has received in form of a liquidity advantage and possibly interest, not the reimbursement in itself. Thus, a possible obligation to repay the state aid element will be very difficult to calculate and carry out, and should under no circumstance amount to the entire reimbursement.

As mentioned, ESA must now evaluate the case, and decide on whether they will open a formal investigation or reject the complaint. If a formal investigation is opened, it will probably take more than a year to reach a decision. This decision may then be brought before the EFTA Court.

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