

### 32.3 An exercise on the potential significance of the capital/revenue decision

The government of an oil-producing country has plans for a tax on the profits of the foreign oil company that is licensed to drill and operate in the country.

The company argues that it should be able to deduct all exploration costs as an expense in the year of expenditure. The government argues that exploration costs should be treated as capital expenditure and amortized at 8% per year.

Comment, and explain some of the consequences of the point at issue.

#### Response

Some points to raise:

1. The company's preference for allowing all exploration costs as an expense in the year of expenditure would lower the company's taxable profits by a substantial amount immediately.
2. The company might argue that without such tax incentives, it might not be able to afford an adequate exploration programme (especially since exploration may not be successful, and even if successful, it would take time to develop and exploit any discovery to the point where it would generate any revenue for the company).
3. The government's preference for amortization at 8% per year would lower the company's allowable expenses for tax in the immediate future, and therefore increase the government's tax revenue.
4. If the company's preference were adopted, it could lead to unnecessary and/or sporadic exploration, merely to reduce the company's current tax liability.