ENR Alert

Finally Issued – The Amendment to Government Regulation No. 79 regarding Cost Recovery and Provisions on Income Tax in Upstream Oil and Gas Activities

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KPMG Advisory Indonesia
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The President signed Government Regulation No. 27 Year 2017 ("PP 27"), an Amendment to Government Regulation No. 79 Year 2010 ("PP 79") regarding Cost Recovery and Provision on Income Tax in Upstream Oil and Gas Activities, on 15 June 2017; it became effective on 19 June 2017, the date it was published.

PP 27 was issued to respond to concerns raised by various stakeholders regarding PP 79. Its aim is basically to improve the investment climate within the industry and increase discovery of oil and gas reserves. It is also expected to improve legal certainty in upstream oil and gas investment activities.

For your reference see also our earlier publication on PP 79 and its implementing regulations.

An overview of new matters introduced by PP 27 and its significant changes to PP 79 is provided below:

1. Transitional options available until 19 December 2017

Transitional options are provided in PP 27 Articles 38A to 38C:

- **Article 38A**

  PSCs signed before the introduction of PP 79 continue to apply until the end of their contract period. A contractor may, however, opt to fully comply with PP 27 by adjusting its existing contract within 6 months after the effective date of PP 27, i.e., by 19 December 2017.

- **Article 38B**

  PSCs signed after the introduction of PP 79 continue to apply until end of their contract period. A contractor may, however, opt to fully comply with PP 27 by adjusting its existing contract within 6 months after the effective date of PP 27, i.e., by 19 December 2017.

- **Article 38C**

  Any PSCs signed after PP 27 became effective must comply with PP 27 requirements.

KPMG Comments:

The intention of this provision is clear: all contractors are expected to fully comply with the provisions of PP 27. However, the government cannot force contractors to follow this regulation as it has to respect the contracts in place. Therefore, the government is providing contractors an option to "voluntarily" comply with this regulation.

A number of business, legal and tax issues need to be assessed before any contractor opts to voluntarily comply with this regulation and subsequently adjust its existing contract:

- Prepare a detailed assessment of the business and tax impacts of the PP 27 matters described below and compare them to current circumstances; and
- Determine whether the change could be done by an amendment to the Production Sharing Contract ("PSC") or would require a new contract;

2. FTP and Incentives

That the Ministry may determine the First Tranche Petroleum ("FTP") amount is maintained. However, the incentives provision of PP 79 Article 10 is further detailed in PP 27. The Article 10 incentives were introduced to woo the development of working areas, including:

i. Upstream incentives in the form of investment credits, Domestic Market Obligation ("DMO") fees, accelerated depreciation and DMO holidays;

ii. Tax incentives, requiring further implementation regulations, which may include existing tax facilities available in other sectors; and

iii. Non-state revenue incentives, specifically referring to the utilization of assets belonging to the government used by contractors in upstream activities.

KPMG Comments:

These incentives are targeted at all PSCs, especially those PSCs that do not contain such provisions. Further implementing regulations are expected to be issued on requirements and procedures.

3. Sliding Scale Split

A new provision on the "sliding scale split", introduced in PP 27 Article 10A, states that the Ministry may determine the amount of the sliding scale split intended to share profits and risks. This is to anticipate any dynamic changes within the industry, especially in relation to changes in prices, production capacity, revenue ratios and operational expenses.

KPMG Comments:

For any existing PSC, any reference to the sliding scale split has been locked in the PSC. We are of the view that this applies only to newly signed contracts or existing contracts which have been voluntarily adjusted in accordance with the provisions of PP 27 Articles 38A and 38B.

4. Cost recovery items

- **Costs in relation to LNG process**

  PP 27 Article 11 clarifies costs in relation to natural gas processing up to the point of delivery. The elucidation of this provision specifically refers to costs in relation to LNG processing.

KPMG Comments:

This provision confirms that exploitation costs include LNG processing costs under upstream scheme.

- **Community development costs**

  PP 79 Article 12(e) is amended making community development costs during the exploitation stage cost recovery items.

KPMG Comments:

This is good for community development around working areas during the exploitation stage. This change was in response to comments that it was not fair to exclude these costs.

- **Negative list of cost recovery items**

  Several cost recovery negative list items under PP 79Article 13 have been removed to be consistent with industry practice and relevant tax provisions:

  i. Employee income tax included as tax allowance;

  ii. Qualified interest recovery; and

  iii. Transactions which inflict loss to the state.

KPMG Comments:

This clarifies that for both PSC and tax provisions that these costs should be treated as cost recovery and tax deductible items.

5. Depreciation expense treatment

- **Unusable assets**

  PP 27 Article 16 allows any remaining book value of assets considered as "unusable" to be directly treated as a cost recovery item.

- **Different depreciation methods**

  PP 27 Article 16 paragraph 5 provides that, in order to increase production, the Ministry may determine different depreciation methods to be used as currently adopted based on this regulation.

KPMG Comments:

This should be part of the incentives offered under PP 27 Article 10, as amended.

6. Calculation of production sharing

PP 79 Article 24 was amended to accommodate a slight change to the upstream incentives offered under PP 27 Article 10.

7. Income tax calculations

There are no significant changes on income tax calculation procedures. However, the following new provisions are included:

- **Timeline to issue tax assessments**

  Tax assessments must be issued within 12 months after a complete tax return is received by the Director General of Taxes.

- **Income tax on FTP**

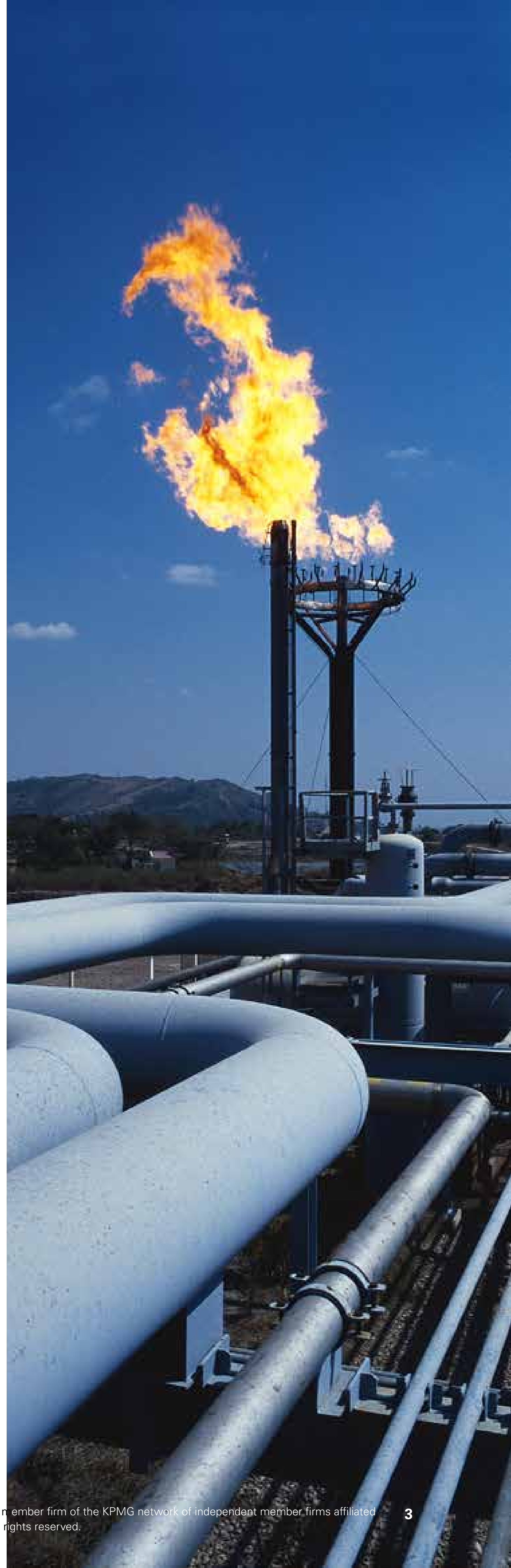
  PP 27 Article 25, Paragraph 12, is merely the inclusion of another regulation which states that income tax on FTP is calculated when the accumulated FTP income is higher than the remaining balance of un-recovered costs.

- **Removal of provisions in relation to exemptions on import duty and tax on importation**

  These provisions were removed as they are regulated under separate new articles.

KPMG Comments:

These are mainly clarifications of current practice within the industry and also to be consistent with the current tax regulations.



8. Tax facilities

Consistent with the aim of this amendment, several long time industry tax disputed areas have been formally clarified in PP 27 Articles 26A, B and C:

- **Tax facilities during exploration and exploitation stage**

  The following facilities are formally included in PP 27:

  i. Import duty exemption on imported goods;

  ii. VAT is not collected on:

     a. acquisition of certain VATable goods/services,

     b. imported goods,

     c. the utilization of offshore intangible goods, and

     d. the utilization of certain offshore taxable services;

  iii. Income tax Article 22 is not imposed on any imported goods/services in relation to upstream activities subject to import duty exemption; and

  iv. Land and Building Tax ("PBB") is reduced to the amount stated in the Tax Payable Notification Letter ("SPPT") issued during exploration stage

  The same facilities also apply to activities during exploitation stage but are granted only by the Ministry of Finance after consideration is given by the Ministry of Energy.

KPMG Comments:

These tax facilities are definitely good news for contractors in the industry. These facilities are targeted to all PSCs, both during exploration and exploitation stages.

The provision on exemption to PBB was issued to respond to industry concerns over significant PBB disputes in the past.

Further implementing regulations will likely be issued on requirements and procedures. Hopefully the new administrative procedures are simplified to reduce those that currently apply.

- **Sharing facilities**

  In another government regulation, a contractor is permitted to share any facility not being fully utilized with others. The intention being to reduce total cost recoveries by sharing these available facilities due to location.

  PP 27 Article 26C clarifies the following issues:

  i. If any facilities are not fully utilized, contractors (subject to SKK Migas approval) may allow the facilities to be used by other contractors based on cost sharing arrangements;

  ii. Cost are allocated to other contractors based on actual costs incurred by the contractor controlling the facilities;

  iii. Some requirements must be fulfilled:

     a. Those facilities belong to the government;

     b. SKK Migas approval has been obtained; and

     c. Sharing is not intended for gaining any profits.

  iv. Sharing facilities is not subject to income tax withholding and VAT.

KPMG Comments:

Although sharing facilities is recognized by SKK Migas, in practice there have been some occasions in the past when the Tax Office has considered these arrangements being subject to withholding tax and VAT. These have been disputed by most contractors, but the outcome of the disputes vary one to another. It is a very good development that this tax issue has been clarified in PP 27.

Further implementing regulations are expected to be issued and we hope there are no new restrictions/limitations provided in them.

- **Head office cost allocations**

  Under both PSCs and Government Regulation, head office costs are allowed to be recorded in PSC books as cost recovery items – subject to some administrative requirements and SKK Migas approval. Similar to sharing facilities, there have been occasions when the Tax Office has viewed these costs as being subject to both withholding tax and VAT.

  PP 27 Article 26D confirms that these cost allocations are not subject to income tax withholding and VAT.

KPMG Comments:

Industry efforts to obtain clarification has been well rewarded. Although allocation of these costs should not trigger any withholding tax and VAT - as there is no transaction between entities – prior to the issuance of PP 27, the industry had been busy with such disputes with the Tax Office.

Further implementing regulations are expected to be issued and we hope there are no new restrictions/limitations provided in them.

9. Income from outside the contract

PP 27 paragraphs 1A and 2A basically state that no further branch profit tax ("BPT") is payable after payments of:

i. 20% tax on uplift income, and

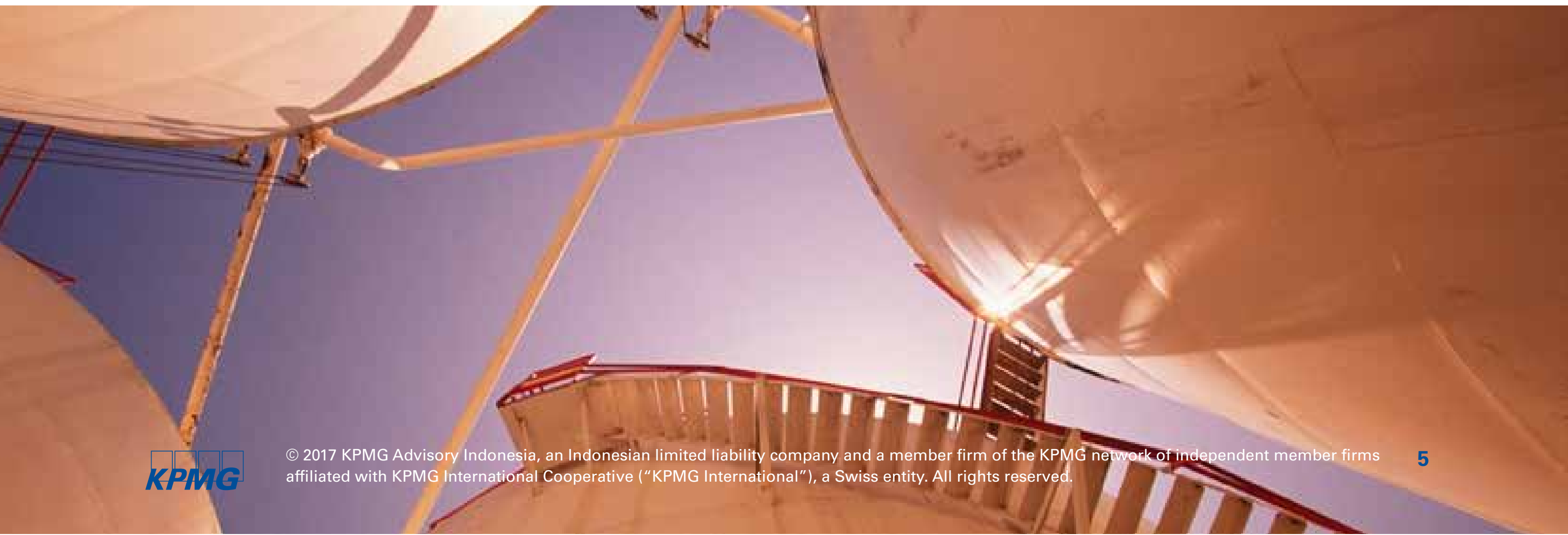
ii. 5%/7% tax on the transfer of participating interests.

KPMG Comments:

This is a very good news for investors and contractors as the imposition of BPT is very burdensome. In the past, the way the Tax Office interpreted the regulation and how it considered "costs" in calculating BPT resulted in significant tax disputes.

However, some questions remain open on whether this provision totally removes BPT on both uplift and transfer of participating interest transactions:

- Whether this applies to contractors whose PSCs were signed before the introduction of Oil and Gas Law in 2001 or their PSCs signed before the introduction of PP 79 – this is relevant for us to understand how Article 37A was drafted. The question is whether contractors who do not opt to adjust their contract to fully comply with PP 27 would be entitled for this BPT exemption.
- Although technically the PP 27 provision should override the contents of Ministry of Finance Decree No. 257/2011 ("PMK 257") (the implementing regulation of PP 79 regarding taxation treatment on income from uplift and transfer of participating interest), there may be questions whether or not another implementing regulation is needed to revoke PMK 257.
- The application of PP 27 to any transaction signed before 19 June 2017, but tax would only be payable later after 19 June 2017 - upon fulfillment of some conditions, including approval from the government;
- Further implementing regulations are expected to be issued and we hope there are no new restrictions/limitations provided in them.



10. Administrative issues

There are some administrative issues clarified in PP 27 Article 30 to be more consistent with current practice and to also regulate tax audits of companies under PSC contracts.

- **Amount of costs**

  The Director General of Taxes is annually required to stipulate the amount of costs, both for companies under exploration and exploitation stages for the purpose of tax calculation. Previously the regulation only referred to the exploration stage.

KPMG Comments:

This provision has not been implemented yet under PP 79 – it should be clear that according to this regulation, the Director General of Taxes would issue its assessment to confirm available costs (cost recovery amounts) of contractors for the purpose of tax calculation. It means that such cost recovery amounts would be subject to audit every year.

- **Guidance on tax audits**

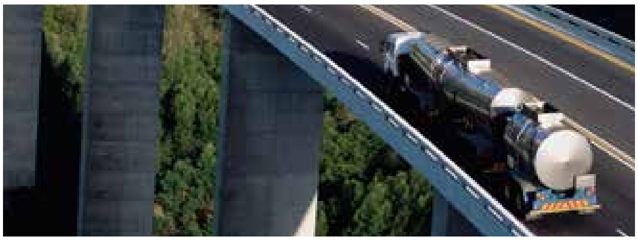
  Further guidance on joint audits of exploration and exploitation costs will be issued.

KPMG Comments:

We are of the view that such joint audits would be done together by the Tax Office, SKK Migas and BPKP (Government Auditor).

- **Reporting of transactions**

  The reporting requirement for transfers of participating interests or transfer of shares under PP 27 paragraph 2 has been extended to the Director General of Oil and Gas. Reporting under PP 79 was only to the Director General of Taxes.



KPMG Comments:

This is an administrative issue – previously the Director General of Oil and Gas may not have been aware of these transactions, especially if they did not require prior approval from the government. Under this regulation, both Directors must be made aware of all direct or indirect transfers of participating interests and shares.

- **Transaction settlement and execution**

  PP 79 Article 35 has been removed by PP 27. Previously it is required that for a transaction executed in Indonesia, any payment settlements must be made using the Indonesian banking system. Any deviation was subject to prior approval from the Ministry of Finance.

KPMG Comments:

It is quite surprise that this provision was removed as this does not appear to be consistent with the intention to boost the use of Indonesian banking system.

11. PSCs signed prior to the issuance of PP 79

PP 27 Article 37A confirms that any PSCs signed before the introduction of PP 79 continues to apply until the end of their contract. In fulfillment of contractor obligations, any matters not specifically regulated under the relevant PSCs, must refer to this regulation, such as:

- The amount of government shares;
- The provision on cost recovery;
- Negative cost recovery items;
- Appointment of independent 3rd party to verify financial and technical cases;
- Issuance of tax assessments;
- Exemption on import duties and other importation taxes during exploration and exploitation stage;
- Contractors' income tax in the form in-kind; and
- Income from outside the contract, such as uplifts and/or transfers of participating interests.

KPMG Comments:

The intention of this provision is to narrow references to PSC provisions in case any interpretation is required. With this provision, the government tries to force all issues to be settled by referring to the regulation unless the PSC clearly stipulates the relevant issues.

A further clarification in the implementing regulation from the Tax Office is required. Learning from the application of PMK 257, we anticipate there may be issues in the future in interpreting PP 27 Article 37A for cases that are not specifically stipulated in the PSC – those may include some of the issues listed above.

12. Reference to Badan Pelaksana updated to SKK Migas ("Upstream Oil and Gas Executive Body").

This merely acknowledges the change of the institution's name after the Constitutional Court decision in November 2012 and the establishment of SKK Migas in 2013.

KPMG Conclusions:

In summary, PP 27 clarifies and resolves some long disputed industry issues, such as cost sharing, head office costs allocation and land and building tax, which are good for existing contractors and also the investment climate within the upstream oil and gas industry.

However, PP 27 has not entirely removed all uncertainties as was intended, especially when discussing the requirements to adjust and comply with current regulations. Although contractors are given an option to comply, however, we anticipate different interpretation will arise from non-voluntary compliance, especially on the 8 issues specifically listed in Item 11 above.

Further implementing regulations/clarifications/guidance are required in order to fully understand and implement this regulation properly.

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This Alert is intended to provide you with a general overview of some of the matters and issues in the contents of PP 27; it is not intended as professional advice. Please consult with your regular contact within KPMG regarding any specific concerns or questions in relation to this new regulation.

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