



cutting through complexity

KPMG GLOBAL ENERGY INSTITUTE

Managing tax in the LNG and FLNG industry: Lessons from the front lines

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LNG report series

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Introduction

The liquefied natural gas industry (LNG) is undergoing unprecedented expansion. The International Energy Agency (IEA) expects global LNG trade to rise by 40 percent between 2013 and 2019. During this period, the IEA expects growth in natural gas demand in Asia to represent half of the world's incremental needs.¹

Meanwhile, floating LNG is emerging as an important technology that offers a fast and cost-effective means to unlock new gas resources. The world's first project – Shell's Prelude project – is advancing off Australia's northwest coast, and various players have plans to install more than 22 FLNG vessels worldwide.²

From a tax viewpoint, however, new technologies and new ways of doing business bring new tax issues – and LNG and FLNG projects are no exception. Investors and operators are challenged to comply with complex income and resource tax regimes and manage indirect taxes and custom obligations across supply chains, while ensuring they don't miss out on exemptions, incentives and recoveries. And, as the experience of Shell in Australia shows, the unprecedented features of massive, mobile FLNG projects create a raft of additional tax complications.

While the current tax environment is complex for foreign investors, the future is more uncertain. LNG and FLNG are attracting government attention. Many countries, among them, Canada, Nigeria and South Africa, are struggling to balance the conflicting goals of raising tax revenues while encouraging LNG activity and attracting investment. Australia is the first country with direct experience with FLNG, and its economic effects have state and national governments reviewing whether tax changes are needed.

All of this flux is occurring as the Organisation for Economic Co-operation's Action Plan on Base Erosion and Profit Shifting unfolds (BEPS), prompting countries like Japan to take a closer look at outbound investment in LNG from a BEPS perspective.

What are the top tax issues affecting the LNG and FLNG industry? To find out, we sought the views of Energy & Natural Resources (ENR) tax professionals with KPMG member firms in South Africa, Nigeria, Japan, Canada and Australia who have first-hand experience advising LNG and FLNG producers and investors in their markets. Based on their insights, this report sets out a number of key takeaways for investors looking into the rapidly expanding LNG and FLNG opportunities that are arising globally.

This is the fourth in a series of LNG reports that provides deeper insights on improving project economics and certainty through better project management, cost transparency, governance, jurisdiction engagement, stakeholders and opportunity selection.



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A senior international tax partner, André is primarily focused on structuring the operations of multinational corporations, advising domestic and foreign clients on cross-border and multi-jurisdictional taxable and tax-free acquisitions and dispositions. He has represented taxpayers in arbitration and competent authority proceedings and tax litigation. André holds a law degree from Groningen University and is a lecturer at the Leiden University International Tax LLM Program. A frequent speaker and writer on international income tax issues, he is also an author of a standard book on the avoidance of double taxation in the Netherlands.

¹ Department of Finance Canada media release, "PM announces measure to support jobs and growth in the LNG industry," 19 February 2015.

² Source: KPMG International, 2014, Floating LNG: Revolution and evolution for the global industry?

Achieving tax certainty amid flux: Lessons from South Africa

LNG tax issues



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Specializing in indirect tax, the corporate and international tax implications of investment into South Africa and Namibia, and oil and gas transactions, Di heads up the Indirect Tax department in Cape Town, as well as the oil and gas tax unit nationally. Her extensive experience includes value-added tax (VAT) implications of joint ventures (JV) for oil and gas exploration and the sale of oil and gas rights and royalty reviews to identify risk and savings. Di also advises on specific tax provisions for oil and gas companies, fiscal stability agreements, the tax implications of JV and joint operating agreements, and advanced tax rulings covering the disposal of participation interest in oil and gas rights.

South Africa is experiencing severe energy constraints, and, among other responses, the government aims to increase the country's reliance on natural gas. Given the high cost of diesel, South African power utility Eskom has been directed to switch from diesel to gas to fuel its generators, and households are being encouraged to switch from electricity to gas for cooking, heating and other uses.³ Under its long-term energy master plan, South Africa will pursue gas, petroleum, nuclear, hydropower and other sources as part of the energy mix.

As the government seeks ways to encourage more natural gas use, more imports from gas-rich neighbors and more exploration and development of the country's own gas resources may be expected. Investors into South Africa need to ascertain the legal and tax framework that will apply to their investment. South Africa currently has no specific legal or tax framework applicable to FLNG projects as opposed to LNG projects, so current legislation would apply.

The State grants rights to explore for, or produce, mineral resources, including oil and gas, under the Mineral and Petroleum Resources Development Act.⁴ Recent proposed amendments to the Act in respect of the State's percentage of free carry interest in new oil and gas ventures has created uncertainty in the industry, and the legislation relating to oil and gas rights is currently under revision. The Act was associated with the Mining Charter, which is applicable to mining companies but not oil and gas companies, which are subject to the Liquid Fuels Charter.

Given the much higher capital needs for developing LNG and other oil and gas investments and other differences between the oil and gas and mining sectors, the government may create separate legislation for the oil and gas industry. The specific details of any new legislation, however, are unknown.

While this uncertainty may dampen natural gas exploration and production activity in South Africa for the time being, the government's priority on natural gas is expected to produce positive results for the LNG industry in the future.

Confirm incentives and obligations in advance

Any new investor would need to assess its proposed activities against the general provisions of South Africa's Income Tax Act to determine if a tax liability is created through, for example, exploration activities or the activity of leasing equipment or ships, construction or other activities that will take place in South Africa, including its territorial waters or areas over which it has jurisdiction regarding the exploration or exploitation of natural resources.

For new LNG investments, it is important to confirm in advance whether the operations would qualify for South Africa's tax incentives for oil and gas activity. Specific concessions are available for oil and gas rights companies (defined as companies that hold oil and gas rights or engage in exploration or post-exploration activities in terms of an oil and gas rights) under the Tenth Schedule to the Income Tax Act. These include a 100 percent uplift (additional

³ South African Government: Energy Challenge; <http://www.gov.za/issues/energy-challenge>

⁴ 28 of 2002.

deduction) for capital expenditure incurred in exploration activities (effectively, activities up to and including field appraisal stage) and a 50 percent uplift on capital expenditure for 'post-exploration' activities (preliminary to refining).

Where these provisions do not apply, other benefits may be available for operations within special economic zones and particular allowances or deductions may be available in respect to specific assets or equipment used.

Investors should also review their VAT and customs and excise obligations – as well as any exemptions or other concessions that may apply. In addition, investors should determine any liabilities for payroll taxes in respect of staff seconded to work in South Africa. Transfer pricing provisions would need to be considered.

Further, liabilities under the Mineral and Resources Royalty Act, which imposes royalties on mineral resources extracted in South Africa, should be determined.



With **upfront planning**, investors can **arrange** their participation in **LNG projects** in ways that ensure that their **tax position** is well defined. ”

— Di Hurworth
KPMG in South Africa





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— Di Hurworth
KPMG in South Africa

Achieve tax certainty with stability agreements

Foreign investors that qualify as oil and gas companies under the Tenth Schedule to the Income Tax Act can achieve a degree of certainty over the taxation of income from their activities by entering a fiscal stability agreement with the government. These agreements offer comfort, for example, that the specific tax rates provided for in the Tenth Schedule would not increase and that specified expenses would be tax-deductible.

Oil and gas companies may also be able to negotiate a separate stability agreement to cap the rate of royalty tax.

Review obligations to contribute to the local economy

Foreign investors in South Africa need to determine their obligations under the country's National Industrial Participation Plan (NIPP). Under the NIPP, foreign companies that gain procurement contracts with state-owned entities worth more than US\$10 million must make offsetting investments in the South African economy. Oil and gas rights holders

may have further obligations regarding site closure and land rehabilitation.

Review the tax effects of proposed investment structures

Given the above, foreign LNG investors should consider the tax implications of their proposed investments in South Africa carefully, including:

- income tax liabilities
- specific tax incentives
- ensuring protection under existing stability agreements
- withholding tax obligations
- transfer pricing implications
- VAT and customs requirements
- payroll obligations
- the ability to deduct start-up losses against future profits
- the ability to claim preferential tax rates, exemptions and other concessions.

With upfront planning, investors can arrange their participation in LNG projects in ways that ensure that their tax position is well defined.

Securing incentives and feedstock security: Lessons from Nigeria

Nigeria has significant natural gas resources – more than any other country in Africa – and is one of the world's top five LNG exporters.⁵ However, a lack of infrastructure results in heavy amounts of flaring and limits the ability of Nigerian operators to derive a more saleable product. A number of current and upcoming projects aim to reduce flaring so Nigerian producers can monetize natural gas more effectively and increase earnings from natural gas exports.

As a result, the Nigerian government offers significant incentives to encourage the development of upstream facilities and operations. At the same time, the government looks to the sector to provide a significant source of much-needed tax revenue.

Special tax regime for oil and gas activities

Currently, Nigeria imposes a special tax regime for oil and gas companies and

for companies providing associated construction and consulting services. Upstream companies resident in Nigeria pay petroleum profit tax at rates ranging from 50 – 65.75 percent for the first 5 years, after which the rate rises to 85 percent. Upstream companies operating in deep offshore facilities under production sharing contracts with the national oil company pay tax at 50 percent. Downstream companies, including LNG facilities, pay the tax at 30 percent, which matches the general corporate income tax rate.⁶

Among the incentives available for LNG facilities, a tax holiday of up to 5 years may be available for new operations. Investment made by an upstream company to separate crude oil and gas from the reservoir into usable products would be considered as part of the oil field development and thus enjoy recovery at the higher petroleum profits tax rate. In addition, gas can be transferred to downstream companies tax- and royalty-free.

LNG tax issues



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Victor has extensive experience in compliance and advisory services covering petroleum profits tax, income tax for companies, indirect taxes and regulatory issues, with a strong focus on companies operating in the Nigerian oil and gas sector. He has led several client engagements on tax compliance management for E&P companies, advised on business restructuring for optimal tax benefits, provided tax advice on major investment decisions, negotiated with federal and state internal revenue services and acted as an expert witness in several arbitration cases regarding petroleum sharing contracts.

Upstream companies resident in
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Source: KPMG in Nigeria, 2015.

⁵ US Energy Information Administration website, Country Analysis Brief Overview, Nigeria
www.eia.gov/countries/country-data.cfm?fips=NI

⁶ Source: KPMG in Nigeria, 2015.



New LNG and other downstream operations can opt out of the 5-year tax holiday and instead claim a 35 percent investment allowance over and above the facility's base cost. These companies can recover 90 percent of the cost of their investment in assets in the first year.

— Victor Onyenkpa, KPMG in Nigeria



New LNG and other downstream operations can opt out of the 5-year tax holiday and instead claim a 35 percent investment allowance over and above the facility's base cost.⁷ These companies can recover 90 percent of the cost of their investment in assets in the first year. LNG companies that opt to take the 5-year tax holiday can, throughout the tax holiday period pay dividends exempt from the 10 percent withholding tax that would otherwise apply (provided the investment in the business was in foreign currency).⁸ In addition, such companies can claim a 15 percent investment allowance after the tax holiday period. This allowance does not reduce the value of the asset for capital allowance claims.

All companies in the sector qualify for 0 percent VAT on machinery and exemption from customs duty on imported machinery. Companies may also qualify for a number of additional incentives, including the ability to claim 120 percent of tax-deductible expenses for research and development (R&D) conducted in Nigeria (which increases to 140 percent for R&D on local raw inputs).

Ensure tax positions are well defined and documented

However, LNG companies can face challenges in securing these

incentives. The Nigerian tax authority is under pressure to increase revenues and often takes a narrow view of the circumstances in which incentives, such as the 0 percent VAT rate, can be obtained. Foreign investors in Nigerian LNG projects should make sure their tax position is clearly defined and well supported in their contracts and other documentation.

Don't overlook tax compliance requirements, even while tax-exempt

LNG companies also need to meet tax filing and other administrative requirements, even during periods when they are tax-exempt. For companies taking advantage of the 5-year tax holiday, tax returns are still due annually and, after the third and fourth years, they need to make special filings to verify the company continues to qualify for the exemption and that its activities are producing economic benefits for Nigeria.

Consider APAs to gain certainty over transfer prices

As in most countries, transfer pricing is a particular concern for non-resident investors in LNG in Nigeria. A new transfer pricing regime was introduced with effect for 2014 and later tax years. The first round of transfer pricing audits is in its early days, and how the



A number of current and upcoming projects aim to reduce flaring so Nigerian producers can monetize natural gas more effectively and increase earnings from natural gas exports.

— Victor Onyenkpa, KPMG in Nigeria

⁷ Source: KPMG in Nigeria, 2015.

⁸ Source: KPMG in Nigeria, 2015.

tax authorities will apply the rules in practice remains to be seen. Guidelines from the Nigerian tax authorities specify that they will honor the terms of an agreement with a government body that defines taxable profits. These agreements include advance pricing arrangements (APA) negotiated with other tax authorities.

Clarify contract arrangements to ensure long-term feedstock security

Finally, it is crucial for LNG companies in Nigeria to ensure the long-term security of their feedstock. Most deep offshore production sharing contracts with the national oil company do not address ownership of gas discovered. Further, the government requires natural gas producers to make certain amounts available for domestic use, and its approval is required before natural gas products can be sold (to LNG facilities) for export.

Proposed tax reforms on hold

Looking ahead, the future taxation of LNG activities in Nigeria is uncertain.

In 2012, the Nigerian government proposed a sweeping Petroleum Industry Bill, which aims to overhaul the regulatory framework and taxation of Nigeria's oil and gas industry. Among other things, the bill would increase already-high taxes on upstream activities, give the Minister of Petroleum discretionary powers to set royalties, and introduce a new mandatory contribution to a fund for economic, social and infrastructure development.

Foreign investors and international oil and gas companies criticized the bill, saying it would discourage badly needed foreign investment in the sector. The bill is under review and seems unlikely to proceed as proposed. As competition in Africa's LNG industry intensifies – especially from Mozambique and Tanzania – there are hopes that the government may decide to pursue a different set of reforms that would do more to attract new investment to Nigeria.



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— Victor Onyenkpa
KPMG in Nigeria



Companies may qualify for a number of **additional incentives**, including:

CLAIMING 120% of tax-deductible expenses for R&D conducted in Nigeria

(which **INCREASES** to **140% for R&D** on local raw inputs).

Source: KPMG in Nigeria, 2015.

Outbound LNG investment: Lessons from Japan

LNG tax issues



Just as foreign LNG investors need to look into the tax and regulatory obligations and concessions in the destination country, they also need to explore the implications of their investment in their home country.

Japan, for example, has scant domestic energy resources, and its capacity diminished even further following the removal of nuclear power after the Fukushima disaster in 2012. Since then, Japan has increased its reliance on imports of more costly fossil fuels, favoring LNG as the fuel of choice for both price and environmental reasons. Today, LNG imports comprise virtually all of Japan's natural gas supply and the country ranks as the largest LNG importer in the world.⁹

Explore the domestic tax implications of offshore investments

Japanese energy companies do not generally participate in foreign natural gas projects as operators. More often, they participate by setting up joint ventures, special purpose companies

or other arrangements with foreign partners to provide services such as engineering, construction and project management.

In principle, Japan exempts from tax 95 percent of dividends received from foreign subsidiaries, provided the Japanese parent company's interest in the subsidiary is 25 percent or more. This ownership threshold can be reduced to as low as 10 percent under a tax treaty. As a result, Japanese gas companies often set up regional holding companies in countries with favorable treaty terms such as the Belgium, the Netherlands and the United Kingdom.

Consider the benefits of regional commodity trading companies

Where a Japanese company earns foreign profits through off-take arrangements, it often makes sense to set up a regional commodity trading company in an established hub such as Singapore, Hong Kong or the United Kingdom. These locations are not only



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— **Kenichi Takashima**
KPMG in Japan

⁹ US Energy Information Administration, www.eia.gov/countries/cab.cfm?fips=ja

tax-effective – they also offer significant non-tax benefits in terms of access to regional markets, business-friendly regulatory policies, and skilled local workforces.

Be prepared to meet substance-based challenges

Tax authorities in Japan are in step with the global trend toward challenging tax-effective, treaty-based structures under anti-avoidance and anti-abuse rules based on a lack of business substance. Even though Japanese companies have not historically engaged in tax planning, they increasingly need to defend longstanding international tax structures against substance-based challenges and other aggressive tax audit practices in emerging economies, as well as in their home country, Japan.

For most LNG operations, the number of personnel, systems, physical facilities and level of commercial activity involved should help to make a sustainable case for the company's valid business purpose and substance. Ensuring that pre-project documents are well organized and thorough, and clearly identify the business rationale

underlying the arrangement, can reduce the potential for negative determinations.

The Japanese tax authorities are also relatively quick to legislate against specific tax planning arrangements that they perceive as abusive. Previously, for example, double non-taxation could result by structuring Japanese investment in Australian LNG and other projects through redeemable preferred shares. Dividends on this type of shares could qualify as exempt in Japan under the participation exemption and as tax-deductible debt in the dividend-paying country. As of April 2016, Japan no longer allows the exemption for redeemable preferred shares, with some transitional arrangements.

Transfer pricing issues present one of the biggest tax risks for Japanese companies with interests in foreign LNG producers or trading companies that are held in low-tax jurisdictions. In setting transfer prices for LNG and other resources, Japan's tax authorities expect companies to follow market prices, which can present challenges in allocating profit to holding or trading companies in low-tax jurisdictions.



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KPMG in Japan





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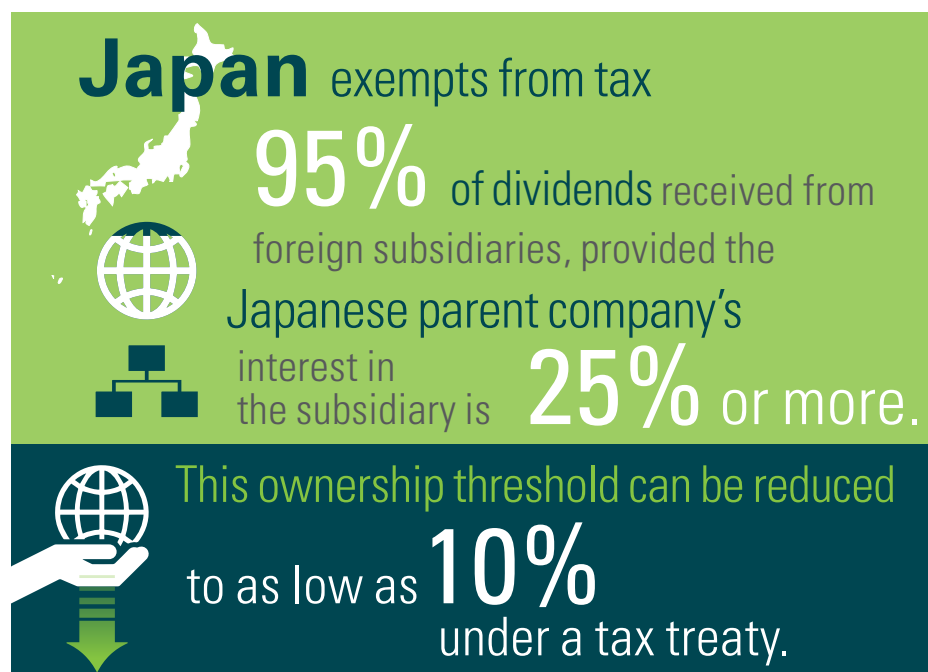
— Kenichi Takashima
KPMG in Japan

Japan's Ministry of Finance is expected to adopt the transfer pricing measures recommended by the Organisation for Economic Co-operation and Development under its Action Plan on Base Erosion and Profit Shifting (BEPS). Under both current rules and any new rules that may come into effect as a result of the Action Plan, the transfer prices of Japanese companies should be accepted as long as the arrangement's business substance is real and well documented, its related-party pricing practices are sound, and comprehensive tax compliance processes are followed. Further

certainty can be gained by entering into an APA with the Japanese tax authority.

Verify, document and monitor implementation of transfer pricing policies

Where the Japanese investor holds only a minority ownership in the LNG facility, the Japanese entity will generally follow transfer pricing policies set by the owner. In these cases, the Japanese investor should review the policies closely to ensure the tax authorities in Japan and other relevant jurisdictions would accept them.



Source: KPMG in Japan, 2015

LNG tax issues

Key actions from South Africa, Nigeria and Japan

1

Confirm tax incentives and obligations related to proposed LNG activities in advance.

2

Review the tax effects of alternative ways of structuring LNG investments.

3

Ensure all tax positions are well defined and documented. In particular, verify, document and monitor the implementation of transfer pricing policies.

4

Be prepared to meet substance-based challenges from tax authorities.

5

Consider opportunities to achieve tax certainty through stability agreements, advance pricing arrangements and other arrangements LNG tax issues with local governments.

6

Don't overlook tax compliance requirements, even during periods when an LNG operation is tax-exempt.

7

Clarify contract arrangements with local governments to ensure long-term feedstock security.

8

Review the domestic tax implications of foreign LNG investments.

9

Consider the benefits of regional commodity trading companies.

10

Review obligations to contribute to the local economy.

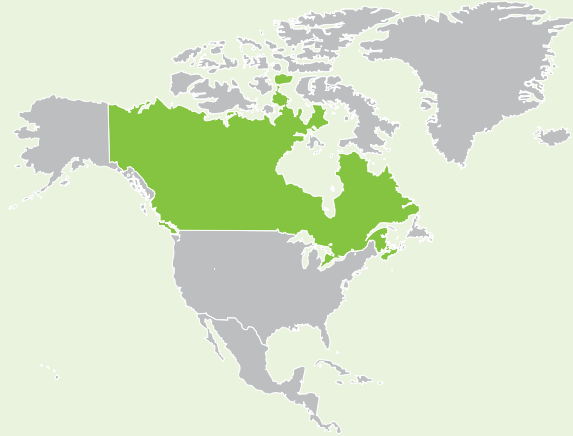
Balancing new and existing taxes to grow LNG exports: Canada



In establishing its **tax treatment for LNG, Canada** has sought to ensure its overall tax treatment remains **globally competitive**.



— **Mary Hemmingsen**
KPMG in Canada



Canada has large natural gas reserves, but limited current access to supply it to emerging international markets where demand is growing. To help ensure that Canadian natural gas can reach new and growing international markets, Canada's federal government announced¹⁰ that it will apply a capital cost allowance rate of 30 percent for equipment used in natural gas liquefaction, which is similar to the rate that applies to manufacturing and processing equipment, and 10 percent for buildings at an LNG facility. This tax treatment is available for capital assets acquired after February 19, 2015, and before 2025.

The federal government says this measure will allow companies investing in new facilities that liquefy natural gas to create jobs and economic growth, while recovering their investment quicker.

In Canada's 2015 federal budget, this treatment was confirmed. The budget also proposed to extend the maximum length of natural gas export licenses from 25 years to 40 years to improve regulatory certainty for natural gas exporters. The budget says this measure takes into consideration "the significant investments required for liquefied natural gas projects, and their significant anticipated economic benefits."¹¹

The federal treatment falls on heels of a downward adjustment in the launching of British Columbia's new two-tier provincial tax on net income from LNG facilities in British Columbia on October 21, 2014. In addition to standard 'income tax', the tax applies an incremental minimum 1.5 percent 'Tier 1' tax on LNG profits before the recovery of capital investment costs and a 3.5 percent 'Tier 2' tax on LNG profits once payback is achieved (rising to 5 percent in 2037 and later years). The new tax rules will apply to income from liquefaction activities at, or in respect of, LNG facilities in British Columbia for taxation years beginning on or after January 1, 2017. Other features of these rules include a new investment allowance when calculating the Tier 1 tax and a new closure tax credit for LNG facilities.¹²



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¹⁰ Department of Finance Canada media release, "PM announces measure to support jobs and growth in the LNG industry," 19 February 2015

¹¹ Department of Finance Canada, *Economic Action Plan 2015*, 21 February 2015.

¹² Source: KPMG in Canada, 2015.



Uncharted waters: Lessons from Australia

Floating LNG tax issues



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With extensive tax experience, Kate specializes in supply chain management of large-scale LNG projects, including Australia's first floating LNG project. She assists clients in minimizing the risk and impact of global VAT/GST, import duties and withholding taxes on major resource projects.

Emerging FLNG technology offers a fast and cost-effective way of developing new gas resources, giving developers the potential to unlock smaller, remote or environmentally sensitive fields with lower capital costs anticipated in comparison to traditional onshore LNG processing. At least 22 FLNG vessels are expected to be in place around the world by 2022, and even more – if the technology proves successful. Shell is hopeful that the Prelude facility, still under construction in Korea, will eventually be secured to the Australian seabed in late 2016 or early 2017.¹³

Where taxes are concerned, FLNG operations are treated similarly to onshore LNG operations and face many of the same issues as onshore LNG. But FLNG's unique characteristics may present some new challenges. The FLNG vessel, whose component parts are designed and constructed overseas and installed in Australia, creates complexities in terms of tax depreciation of capital costs, VAT/GST and customs obligations and recoveries, and access to incentives for innovation. The FLNG project may also provide tax effective financing opportunities such as leasing the vessel. However, moving activity offshore is thought to lessen the operation's overall local economic impact compared to land-based LNG processing, which has already raised objections from local politicians and community groups.

As operator of the world's first working FLNG vessel, Shell is having to work through many of these tax complexities in the Australian context. The lessons learned in this process may highlight some of the top tax issues to address when planning FLNG projects.

Review local income and resource tax regimes

Where an FLNG project is located within Australia's territorial waters, the income tax consequences are much the same for LNG and FLNG projects. Most gas fields are within Australia's economic exclusive zone of 200 nautical miles. For Australia tax purposes, the FLNG project would be subject to petroleum resource rent tax (PRRT) at 40 percent (on upstream activity) and income tax at 30 percent, although the PRRT is deductible for income tax purposes.¹⁴

While the PRRT regime applies in the same way to FLNG and LNG projects, significant practical issues arise related to the allocation of the FLNG capital and operating costs to the 'upstream' and 'downstream' phases of the liquefaction project. These allocations are a key driver for determining PRRT assessable receipts and deductible expenditures.

Additional complications can arise where wells are drilled in, or partially within, the Joint Petroleum Development Area (JPDA) within the Timor Sea, as can be seen with the Sunrise LNG Project which lies 20 percent within the JPDA and 80 percent within Australia's jurisdiction. Timor-Leste receives 90 percent of the upstream revenue in taxes and royalties from any petroleum resources within the JPDA.¹⁵ The joint venturers, including Woodside and Shell, claim that processing of the gas onshore in Timor-Leste is commercially less viable than the use of FLNG.

However, the countries have been in dispute regarding the Treaty on Certain Maritime Arrangements in the Timor Sea (CMATS) signed on 12 January 2006, which split the government revenues

¹³ Source: Shell International Ltd., 2015.

¹⁴ Source: KPMG International, 2014; Floating LNG: Revolution and evolution for the global industry?

¹⁵ Source: KPMG in Australia, 2015.



Whatever the jurisdiction, the **key** is to consider **what's different** about **FLNG** – and **what's common** to all **LNG investments** – and to plan to manage the **tax implications accordingly**.



– Kate Law, KPMG Australia



for Greater Sunrise 50:50, and agreed in 2014 to work towards a settlement. The joint venturers require the Timor-Leste and Australian governments to agree the legal, regulatory and fiscal regime applicable to Sunrise to proceed.

Plan to optimize R&D incentives

FLNG requires significant R&D and a focus should be on capturing relevant data and ensuring maximum value is obtained by ensuring the R&D occurs in jurisdictions and under arrangements that attract the most R&D benefits from a global perspective.

In Australia, the major mechanism and program for fostering innovation is a tax-based scheme rewarding expenditure on R&D activities. The R&D Tax Incentive Scheme is a broad-based program accessible to all industry sectors. Activities conducted as a part of an FLNG project may be eligible for the R&D tax incentive, providing applicant companies are able to demonstrate that new knowledge is being developed through an experimental project. This may include for a wide variety of activities, including sub-sea, subsurface and vessel design.



Contract terms should require suppliers and **contractors to pursue all indirect tax concessions**, exemptions and incentives and to pass the savings on to project owners. Otherwise, **cascading indirect taxes** and higher import **Goods and Services Tax (GST)** can result.



— Kate Law
KPMG Australia

The R&D benefit is a 40 percent non-refundable tax offset for companies with aggregate turnover of 20 million (AUD) or more and 45 percent refundable tax offset for companies with less than AUD 20 million.

Consider the implications of overseas construction

Overseas construction of the FLNG vessel means non-resident producers can stay out of the Australian tax net (withholding tax, GST) during the construction phase. But this creates other issues. For example, for tax depreciation, the owner needs to have sufficient information to properly depreciate the FLNG assets. Determining the cost of component parts can be difficult.

Manage indirect taxes across the supply chain

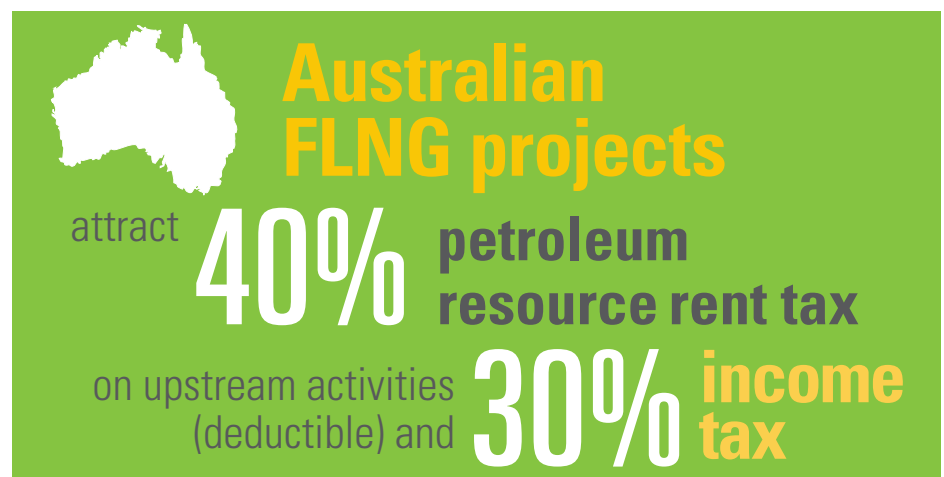
Indirect taxes can be significant for FLNG projects, given the global supply chain involved in constructing FLNG vessels, with inputs sourced from a number of jurisdictions to be modularized in another country and

with the vessels then floated to the jurisdiction of production. But with upfront procurement planning and considered contracting terms, there are opportunities to reduce and/or recover global indirect taxes. It is important to map the flow of goods and review contracts between the owner; engineering, procurement and construction contractors (EPC); and suppliers and sub-suppliers. Contract terms should require suppliers and contractors to pursue all indirect tax concessions, exemptions and incentives and to pass the savings on to project owners. Otherwise, cascading indirect taxes and higher import GST can result.

Review customs and excise obligations

FLNG requires a range of approvals from Australian Customs to allow it to attach itself to the Australian seabed. These approvals are required to be considered and applied for within adequate timeframes.

While a floating structure, such as an FLNG vessel, may not attract customs



Source: KPMG Australia, 2015.

duty, the sub-sea gas gathering system and its components, may attract duty. It is therefore necessary to examine all components of the structure and what, from a customs perspective, is considered to be a part or ancillary apparatus in the same manner as a land-based LNG facility, as this will impact the duty liabilities.

LNG is an excisable fuel in Australia. Consideration is required to be given to the excise treatment and the myriad of excise licenses and permissions that are required to be applied for – even if the LNG is ultimately exported.

Consider employee tax issues

With FLNG, much of the labor is moved offshore, so Australia forgoes significant employment taxes, for example, state payroll tax, which is politically unpopular with state politicians. Outbound relocations are also common in the industry, with employees travelling to other jurisdictions to supervise planning and construction. This can cause foreign tax obligations for employees and also for the Australian owner if the employees' presence creates a permanent establishment in the country of relocation.

These issues are relevant to LNG and FLNG operations alike, and they may have greater visibility to tax authorities if the proposed country-by-country reporting is adopted. Despite some misconceptions, personnel working on the FLNG vessel (in Australian waters) have similar personal income tax obligations to those working onshore.

Flexibility in project financing

FLNG can be financed differently from onshore LNG projects. There is greater scope to lease the vessel, opening opportunities to increase gearing levels. If the lessor is a related company, the lease payments will need to be supported

from a transfer pricing perspective. Lease payments are generally deductible for income tax and provide greater flexibility when the vessel is moved out of Australian waters. Leasing also permits GST structuring as leases executed outside Australia are not subject to GST on ongoing payments.

Engage and address local economic impact

In conventional floating production storage and offload (FPSO) projects with onshore processing plants, gas pumped from the seabed is transferred by pipeline to an LNG plant. Because FLNG projects are completely offshore, they involve much less infrastructure and generate less onshore economic activity and local tax revenue.

These issues, and the announcement by Woodside that onshore processing would be abandoned in favor of FLNG as the preferred development concept for the Browse Project, are spurring Australia's state governments to urge the federal government to consider tax rules to better accommodate FLNG projects. The government of Western Australia (WA) is investigating FLNG's impact on the state and issued a paper¹⁶ in May 2014 that aimed to "explore the impact of the use of FLNG technology on the engineering and design, manufacturing and fabrication, and construction and ancillary services sectors of the WA economy." The inquiry also investigated the impact of FLNG on WA's domestic gas and the impact on state government revenue.

A key finding of the WA enquiry is that "the development of FLNG technology to process Australian petroleum resources represents a particular challenge to WA, due largely to the limited opportunities available to local content providers, for a variety of reasons. FLNG will also generate



Despite some **misconceptions**, **personnel working** on the **FLNG vessel** (in Australian waters) have similar **personal income tax obligations** to those **working onshore**.

— Daniel Hodgson

International Executive Services Partner
KPMG Australia

¹⁶ Australia Legislative Assembly, Economics and Industry Standing Committee, *The impact of floating LNG on Western Australia: Volume 1*, May 2014.



Because **FLNG** projects are completely **offshore**, they involve much **less infrastructure** and **generate less onshore economic activity** and **local tax revenue**.

— Kate Law
KPMG Australia

less income for Western Australia than processing the same fields using onshore processing, which is something that should be of serious concern to the state government.”

To meet such concerns, companies are likely to have to place some infrastructure onshore – for example, supply bases, heliports and FLNG training centers – and possibly even some of the shipbuilding in-country, requiring up-skilling of local yards. Shell, for example, has stressed that 70 percent of annual operating costs will be spent in Australia, with policies to encourage local and indigenous suppliers.¹⁷

Whether Australia’s federal government will adopt new tax rules to address these

concerns is unknown. This highlights the importance of engaging with state as well as federal government and other relevant stakeholders early to address concerns and communicate the benefits of FLNG, including the reduced environmental impact.

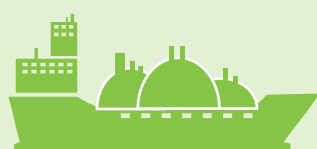
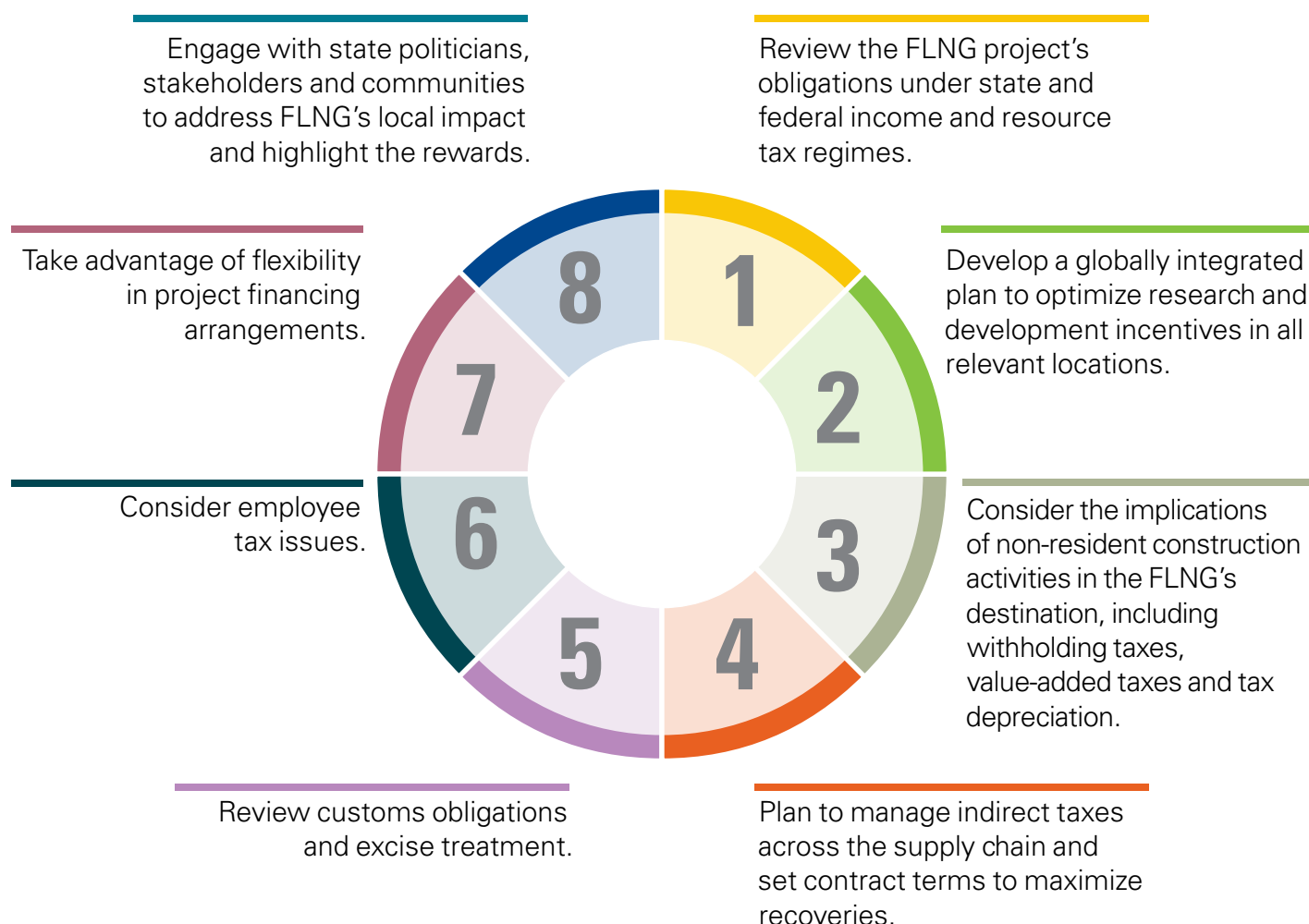
Many of these issues will be encountered in the context of new FLNG projects in other jurisdictions, and a range of other tax issues will undoubtedly arise, depending on the locations of construction, processing and other activity. Whatever the jurisdiction, the key is to consider what’s different about FLNG – and what’s common to all LNG investments – and to plan to manage the tax implications accordingly.



¹⁷ Source: KPMG International, 2015: Unlocking the supply chain for LNG project success.

FLNG tax issues

Key actions from Australia



Shell has stressed that **70 percent** of annual operating costs will be **spent in Australia**, with policies to encourage **local** and **indigenous suppliers**.



Key questions for LNG tax executives

Have we investigated and confirmed the tax incentives and requirements related to our LNG activities in all relevant jurisdictions?

Are we optimizing our access to research and development incentives in all relevant locations through a globally integrated plan?

Have we explored the tax effects of alternative ways of structuring our LNG investments?

Are the rationale and documentation of our tax positions strong enough to withstand possible tax authority challenges?

Have we sufficiently verified and documented our transfer pricing policies? How strong are our processes for monitoring their implementation?

Are we making the most of opportunities to achieve tax certainty through advance pricing arrangements and other arrangements with local governments?

Do we have a globally integrated plan for managing indirect taxes and maximize recoveries across our global supply chain?

Are we fully aware of the domestic tax implications of our foreign investments in LNG projects?

How well do we understand our project's local impact and proactively engage with local stakeholders? Do we meet our voluntary and statutory obligations to contribute to the local economy?

Conclusion

As the LNG industry continues to expand across the globe and as more FLNG projects are realized, additional tax complexities for international investors will undoubtedly arise, especially as individual countries transpose the OECD's final BEPS proposals into local law. Some tax issues are common to other international oil and gas projects, while others are unique to the industry or to the project's location.

Tax issues are one of many non-technical issues to consider. As we explore in other KPMG Global Energy Institute reports in our LNG series (see Further insights on page 23), remote locations, political sensitivities, regulatory landscapes and organizational models are examples of equally important challenges. While taxes are unlikely to drive LNG investment decisions on their own, they can profoundly affect the operation's profitability – whether by attracting unwanted attention and aggressive assessments from tax authorities or by boosting after-tax profits through investment incentives and other concessions.

As with any international business endeavor, the key to success for LNG and FLNG projects from a tax viewpoint is to take a globally integrated approach toward managing your organization's tax matters, while ensuring your bases are well covered locally in every relevant jurisdiction.

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For KPMG's Global Energy & Natural Resources Tax practice, the energy and natural resources industry is a top strategic priority, and we have assembled a core team of tax specialists covering all ENR segments. The team, which includes KPMG lead partners working with major global ENR clients, meets frequently to discuss industry trends and identify opportunities for our member firms' clients. We also host an annual ENR Tax Masterclass training session to share industry knowledge across our member firms' client service teams.

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For more information, visit:

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Further insights



Unlocking the supply chain for LNG project success

LNG developers are facing the challenges of lower oil and gas prices, and consequent reductions in capital expenditure, along with more remote and challenging projects.



Floating LNG: Revolution *and* evolution for the global industry?

After a lengthy period of R&D starting in the 1970s, floating LNG (FLNG) plants are on the verge of entering service, with five due to begin operations between 2015-19. Sixteen other FLNG projects have been announced as probable and 22 as possible.



Major LNG projects: Navigating the new terrain

The LNG industry is approaching an unprecedented wave of expansion as new projects in Western Canada, the US Gulf Coast and East Africa pose technical challenges and more importantly – non-technical challenges.

For further publications, videos and other LNG insights, please visit: kpmg.com/LNG



Commodity Trading Companies

This new global report Commodity trading companies – Meeting the challenge of tax and regulatory change is a follow-up to the 2012 report, Commodity trading companies: Centralizing trade. In this report, ENR professionals with the member firms of KPMG International take stock of the trends and developments that are transforming the commodity trading sector.



Taxes and Incentives for Renewable Energy

KPMG's Taxes and Incentives for Renewable Energy – 2014 is designed to help energy companies, investors and other entities stay current with local country policies and programs supporting renewable energy around the world.



OECD BEPS Action Plan – Global Survey of Tax Executives

This KPMG Global report examines how tax executives around the world are managing the impact of OECD BEPS developments and preparing for the new tax landscape.

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These centers enable KPMG professionals to transfer knowledge and information globally,

quickly and openly. With regular calls and effective communications tools, member firms share observations and insights, debate new emerging issues and discuss what is on their clients' management agendas.

The centers also produce regular surveys and commentary on issues affecting the industry, business trends, changes in regulations and the commercial risk and financial challenges of doing business.



What sets KPMG apart

Our **business model** enables our network of **industry experts** to work **side by side** with **business leaders** to help **develop** and **deliver strategies** or **solutions** using highly **specialized teams tailored** to the specific **business needs** of **member firm clients**.

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Launched in 2007, the GEI is a worldwide knowledge-sharing forum on current and emerging industry issues. This vehicle for accessing thought leadership, events, webcasts and podcasts about key industry topics and trends provides a way for you to share your perspectives on the challenges and opportunities facing the energy industry – arming you with new tools to better navigate the changes in this dynamic arena.

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Designed by Evalueserve.

Publication name: Managing tax in the LNG and FLNG industry: Lessons from the front lines

Publication number: 132404-G

Publication date: July 2015