PwC Indonesia
Energy, Utilities & Mining NewsFlash

New Tax Rules for Gross Split PSCs

On 28 December 2017, the Government issued GR No.53/2017 ("GR 53") providing an initial outline of the tax rules for the recently introduced "gross split" PSCs. This is an important development, allowing investors to better model the economic outcomes of the gross split PSC.

Readers will recall that the Ministry of Energy and Mineral Resources ("MoEMR") mandated in early 2017 that all new PSCs, including extensions to existing PSCs, were to follow a new "gross split" format from 1 January 2017 (see PwC NewsFlash No.60/2017 of February 2017 dealing with MoEMR Reg.08/2017). The gross-split format is also available to existing PSC holders if they elect to convert their "traditional" PSCs.

The key outstanding matter had been the fiscal rules to apply to the Contractor's production share under the gross split PSCs. Speculation had centred on whether (say) the existing tax law might apply on an unmodified basis or even if some type of deemed profit basis might be used.

This was noting that the existing upstream tax rules as (now) set out under GR 27, and so including the long standing "uniformity principle", would (presumably) not apply in a gross split environment (see PwC NewsFlash No.62/2017). This was because the existing upstream tax rules utilised cost recovery as the essential criteria for determining tax deductibility. As the fundamental change with gross split PSCs was the discontinuation of the cost recovery mechanism then the uniformity principle could therefore also no longer be the centrepiece driving deductibility.

As GR 53 has only just issued we are still reviewing its overall impact in detail. However, some preliminary comments on the key points are set out below. More detailed comments will be provided in future NewsFlashes.

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Key Tax Principles

These include:-

a) that, pursuant to the preamble, GR 53 flows from Article 31D of the Income Tax Law and, perhaps surprisingly, Article 16B of the VAT Law (which is discussed further below). As expected, there is no reference to GR 79/GR 27 meaning that GR 27 is not relevant to gross split PSCs;

b) that, pursuant to Article 18, "Taxable Income" arising from "direct" PSC activities is to be "gross income" less "Operating Costs" (see below) but with a 10 year tax loss carry forward entitlement. This 10 year period is greater than the 5 years available under the general tax law, but a significant reduction from the unlimited carry forward entitlement under traditional PSCs.

   It is our understanding also that gross split PSCs will generally follow a Plan of Development ("PoD")-based approach (i.e. rather than a field or contract area-based calculation). It is presumed that a Contractor's tax calculation should also follow this approach although this is not stated in GR 53;

c) that, pursuant to Articles 18(4) and (5), Taxable Income in this most general "direct" scenario is to be income relating to liftings, as well as sales of by-products and other "economic gains" (see below). The taxable income is then subject to tax at the general rate applying at the time of signing the PSC in question (currently 25%) and (where applicable) a branch profits tax ("BPT" - currently 20%) on after tax profits. These rates are however not fixed and so will move with any changes in the general tax law.

   There is however no apparent prohibition on the utilisation of tax treaty relief, potentially opening the way to BPT reductions where relevant treaty relief is validly available.

   In addition the tax calculation appears to be Contractor-specific rather than following a PSC "cut-back" approach. In other words it appears that individual Contractors could (validly) calculate taxable income outcomes different to that for the PSC as a whole. A range of issues could arise however if this is the case including how individual Contractors will ultimately be tax audited etc in the absence of a "PSC-driven" audit process such as that which currently happens under BPKP and SKK Migas;

d) that, pursuant to Article 14, the gross split taxing point begins at the "point of transfer" of the relevant hydrocarbon to the Contractor. This continues the traditional PSC approach whereby economic value is initially recognised upon the Contractor taking title to their share of hydrocarbons via a lifting entitlement under the PSC rather than (necessarily) via a sale of the hydrocarbons. This should also mean that income from post lifting activity (e.g. trading) should not fall within GR 53;

e) that the value of oil is to be determined using the Indonesian Crude Price ("ICP") (Article 15) and that the value of gas is to be determined via the price agreed under the relevant gas sales contract (Article 16). Again this is in line with traditional PSCs;

f) that, pursuant to Article 19(1), income separately arising from "uplifts" is subject to tax at a final rate of 20% of the uplift amount. This is consistent with the taxing outcome under GR 27;

g) that, pursuant to Article 19(2), income arising specifically from PSC transfers is subject to tax at 5% or 7% of transfer income (according to whether the PSC is in exploration or exploitation) and with no further tax due on after tax income. This should mean that no BPT should be due on income from PSC transfers which is also consistent with the revised arrangements under GR 27 for traditional PSCs.

However, and also similar to GR 27 (and PMK 257) there is no detail on many of the controversial aspects of taxing PSC transfers. This includes what actually constitutes consideration for entity based transfers and the exact circumstances of when such transfers are deemed to occur (e.g. by providing tracing rules on how to appropriately determine underlying changes in ownership).

Also absent are any special concessions (say) for inter group re-organisations where the transfer occurs within a particular group.

A Ministry of Finance ("MoF") Regulation dealing with remittance and withholding arrangements on PSC transfers is also still to issue.

Tax Calculation

Key Features include:-

a) that, pursuant to Article 4, a Contractor's "gross income" shall consist of both:-

   i. gross income "directly" from PSC activities; and
   ii. gross income from activities "outside" PSC activities;

b) that gross income from "direct" PSC activities is essentially the Contractor's share of oil/gas realised from liftings, less domestic market obligations ("DMO"), plus compensation for DMO, plus/minus lifting price variances;

c) that gross income from "outside" of direct PSC activities constitutes income arising from:-

   i. uplifts;
   ii. transfers of PSCs;
   iii. sales of "secondary" (by-) products arising from upstream activities;
   iv. other amounts resulting in an "economic benefit" (which the elucidation indicates will extend to contractual penalty entitlements, etc.).

   As indicated in the "Key Tax Principles" discussion above, items i) and ii) are subject to specific final tax arrangements whilst items iii) and iv) are simply added to income arising from "direct" PSC activities;

d) that, pursuant to Article 5, "Operating Costs" include:-

   i. "Exploration Costs" including those in respect of exploration drilling, general and administrative activities and geological and geophysical activities;
   ii. "Exploitation Costs" including those in respect of development drilling, direct production (for oil or gas), processing activities, utilities, general and administrative activities, as well as depreciation and amortisation; and
   iii. "Other Costs" including those in respect of the transportation of hydrocarbons, post operational activities and marketing, as well as for reimbursements paid to prior Contractors in the event that a PSC is terminated pursuant to relevant regulations. LNG processing costs, up to the point of LNG transfer, are specifically mentioned in the elucidation;

   For both exploration and exploitation "general and administrative" activities are to include finance costs as well as "indirect taxes, regional taxes and regional levies". Interest costs nevertheless remain non-deductible (see comments on Article 8 below). Indirect taxes are therefore now also only deductible rather than reimbursable meaning that gross-split PSCs are generally economically inferior to the "assume and discharge" arrangements available under many traditional PSCs.

Limitations on Deductions

Key Features include:-

a) that, pursuant to Article 7, the deductibility of all Operating Costs (outlined above) are still subject to the satisfaction of a series of general criteria. These include:-

   i. that pricing must follow arm's-length principles. This opens the door to more mainstream transfer pricing requirements for related party transactions in the upstream space;

   ii. that oil and gas operations must follow "good" business practices and be in accordance with the relevant work programs. It is however not clear how detailed the residual work program approval process is required to be noting that, if strictly enforced, this could be seen as effectively creating a *de facto* uniformity principle;

   iii. that depreciation is subject to the asset in question being held by the State. This is similar to traditional PSCs;

   iv. that direct "head office" charges must relate to activities that cannot be "procured locally". This requirement will hopefully be supported by guidelines on how to measure/determine what can or cannot be "procured locally" as this could otherwise be quite subjective in practice.

      In addition, "indirect" head office allocations must be within MoF guidelines and be supported by financial information (e.g. audited financial statements of the relevant head office entity).

      Interestingly, neither category of head office costs appears to be limited to "Operators" potentially leaving open the possibility for all Contractors to achieve deductions for their individual head offices expenses (where validly connected to PSC activities);

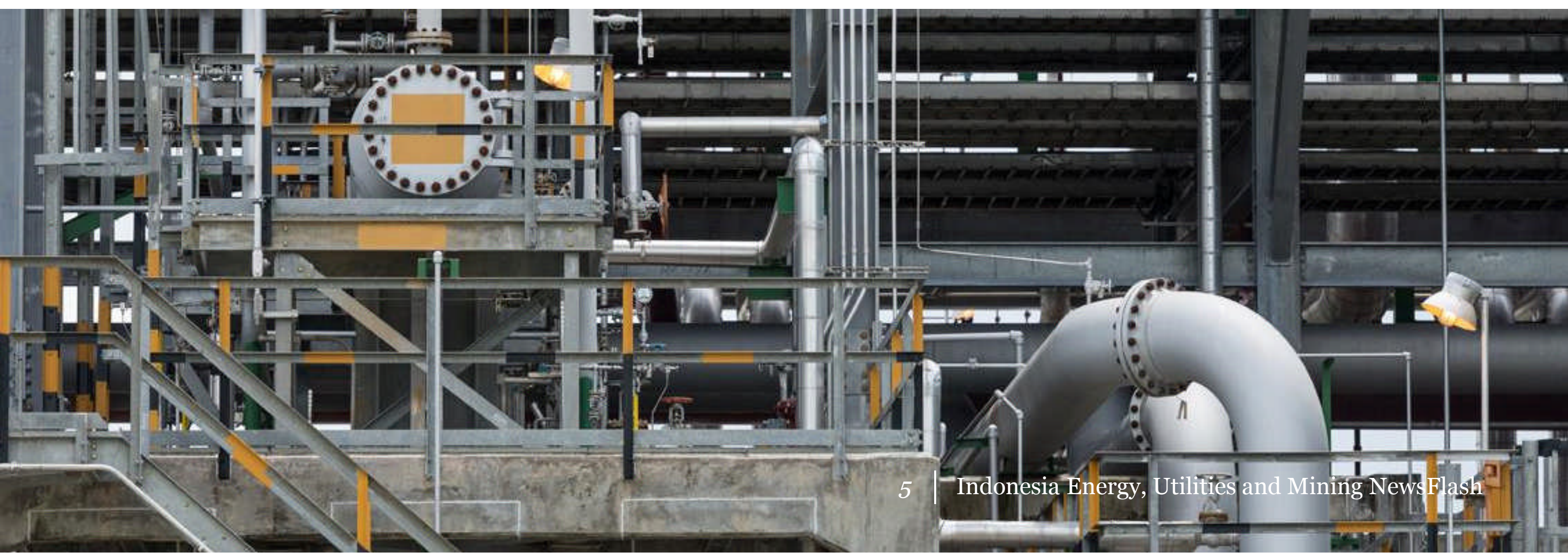
      Indirect head office charges are also exempt from Income Tax and VAT under Article 27;

   v. that the deductibility of spending on a range of other items, e.g. benefits-in-kind, donations, environmental activities and foreign manpower, are to comply with existing regulations.

b) that, pursuant to Article 8, there is no deduction allowed for spending in respect of:-

   i. administrative sanctions, fines, etc.;
   ii. payments of Income Tax;
   iii. incentives, pension contributions, etc. for foreign manpower, etc.;
   iv. the costs of foreign manpower without a work permit;
   v. legal expenses with no direct relationship to upstream activities;
   vi. costs in respect of mergers, acquisitions or PSC transfers. The elucidation extends this to spending on consultants, corporate re-branding, management changes, etc.;
   vii. interest costs;
   viii. royalties. The elucidation extends this to payments allowing Contractors access to operational technologies;
   ix. third party Income Tax where (effectively) borne by the Contractor;
   x. Government bonuses.

      Most of these restrictions mirror the restrictions set out at Article 13 of GR 27. This is except for costs for marketing (as indicated above), tax consultants and commercial audits which now seem to be deductible.



Pre-Production/Deferred Spending

Key Features include:-

a) that, pursuant to Article 12, all pre-production spending, including that otherwise constituting an outright deduction or expense, is to be capitalised. Amortization of this capitalised spending is then to commence from the month of commercial production and on a unit of production basis. This deferment measure should temper some of the concerns about the loss of an indefinite tax loss carry forward criteria under the gross split PSCs (see comments above);

b) that, pursuant to Article 9(1), post production spending on amounts creating economic value of less than 1 year should be deductible in the year incurred;

c) that, pursuant to Article 9(2), post production spending on amounts creating economic value of more than 1 year should be depreciable (if relating to tangible assets) or amortisable (if relating to non-tangible assets);

d) that, pursuant to Article 10, depreciation should be on a declining balance basis commencing in the month the relevant asset is "placed into service" and at rates set out in the Attachment to GR 53. The relevant elucidation defines "placed into service" as the time when the assets are utilised and have fulfilled the conditions/requirements set out by SKK Migas. Again, the linkage to SKK Migas criteria could create a question around a *de facto* uniformity principle;

e) that, pursuant to Article 11, amortisation should be on a unit of production basis commencing from the month the expense is incurred;

f) that, pursuant to Article 13, spending on approved reserves for remediation, etc. is deductible in the year in which the contribution is made to a specifically approved joint bank account with SKK Migas, etc. Any ultimate differences between the reserves and realisation shall be taxable or deductible as the case may be.

Administration

That, pursuant to Article 22, all Contractors are required to:-

a) register for tax;
b) file annual tax returns;
c) perform tax payments including making monthly tax instalments based on each Contractor's liftings of each prior month;
d) report any PSC transfers to both MoEMR and MoF.

That, pursuant to Article 23, all Operators are required to:-

a) deal with the WHT obligations of the PSC itself. These obligations presumably extend only to all jointly incurred costs. A question however arises on remittance for any individual Contractor-only spending;

b) to manage the bookkeeping of the PSC itself. These obligations extend to the keeping of the general financial records including traditional financial statements which (presumably) will now also become the key fiscal documentation. This is noting that PSC specific records may no longer exist (e.g. FQRs).

Incentives

That, pursuant to Article 25, for the pre-production period (i.e. exploration and development) these incentives include:-

a) an exemption from Import Duty on goods used in relation to oil and gas operations. It is however, technically curious how this can be provided without a general reference or reliance on the Custom's Law;
b) the non-collection of VAT on the import or local procurement of goods and services used in operations. This is obviously a wide ranging incentive which, in relation to in-country procurement at least, is potentially superior to that under traditional PSCs;
c) an exemption from Article 22 on the import of goods entitled to an Import Duty exemption outlined in a) above;
d) a 100% reduction in land and buildings tax ("PBB").

These incentives are subject to further regulation by the MoF and so any qualifying criteria within these rules will be of critical importance.

There are however, no incentives being offered for post-production activities (presumably) meaning that all such taxes should simply be deductible.

In addition, pursuant to Article 26, where during the post-production period excess capacity associated with certain upstream assets is made available to other Contractors on a cost sharing basis then the cost sharing receipts shall be exempt from Income Tax and VAT where a number of conditions are met.

Conclusion

GR 53 provides only the initial fiscal framework for gross split PSCs with a number of implementing regulations still to issue. While at this stage the general fiscal framework appears broadly in line with that for traditional PSCs further regulations will be required before Contractors can draw more definitive conclusions.

Nevertheless an early analysis is that the key fiscal differentiators under the gross split PSC include:-

a) that Contractor-specific tax calculations are applicable rather than each Contractor following a PSC "cut-back" approach;
b) that there is an apparent PoD-based tax calculation rather than a field or contract area-based tax calculation. This is however not certain;
c) that a 10 year tax loss carry forward restriction applies (albeit with an automatic deferment during pre-production) rather than the indefinite period under traditional PSCs;
d) that there is no apparent "lock down" entitlement to a tax rate applying to general liftings income thereby leaving the Contractor exposed to any changes in the general tax rates;
e) that there are no apparent prohibitions around treaty use leaving open the possibility to leverage treaty reductions particularly in relation to BPT;
f) that there is a loss of the "assume and discharge" entitlement meaning essentially that all (deductible) spending will need to be determined at its after tax cost;
g) that there is a likely exemption of all "non-Income Tax" taxes during pre-production but an absence of any incentives during the post-production period;
h) that there is potentially greater certainty on the treatment of certain post-production costs such as for marketing and processing.

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