Canada’s BC province tables LNG income tax legislation

Executive summary

On 21 October 2014, the British Columbia Government tabled draft legislative proposals for the new provincial liquefied natural gas (LNG) income tax (the BC LNG tax), as well as for a related natural gas corporate income tax credit.

The legislative proposals include a number of substantial changes to the LNG tax regime previously described in the 2014 provincial budget, including a reduction in the tier 2 tax rate to 3.5% until 2037. The proposals provide some eagerly awaited clarity on BC’s tax regime for the LNG industry.

Detailed discussion

Introduction

The global and BC LNG market continues to evolve rapidly. A number of factors – including competitive US projects progressing more quickly than anticipated, pressure on global energy prices, concerns regarding project cost escalation, regulatory hurdles – have resulted in market conditions that are much different than they were even a few months ago. With recognition of the changing global LNG market, the province tabled the widely anticipated BC LNG tax legislation and a related corporate income tax credit measure.

With the introduction of the BC LNG tax legislation, industry participants can, with greater certainty, incorporate tax considerations into determining the overall viability of their projects. However, the market continues to develop and tax is only one of the factors that will determine the competitiveness of a Canadian LNG project. Global supply and demand considerations, costs (both capital and ongoing operating), environmental approval conditions, First Nations support and the state of the global debt and equity capital markets will all be critical for a viable project.

This Alert summarizes the key aspects of the proposed BC LNG tax legislation and certain observations regarding the tax’s potential impact.
Overview of the LNG tax
The BC LNG tax is a provincial income tax proposed to apply for taxation years beginning on or after 1 January 2017 to income from liquefaction activities at or in respect of an LNG facility in BC. The LNG tax may apply to any taxpayer carrying on such liquefaction activities, regardless of whether the taxpayer has a permanent establishment in BC and regardless of whether the taxpayer is subject to regular federal or provincial income tax.

Who is subject to the LNG tax?
The BC LNG tax applies to a person (corporation or trust, with special rules for partnerships) that engages in or has income derived from liquefaction activities in BC. The tax applies only in respect of a ring-fenced set of activities, from a commodity entering a BC LNG facility to a commodity leaving the LNG facility. If there is no actual transaction at these transfer points, sales or purchases (as applicable) are deemed to occur at such transfer points as determined in accordance with legislative rules and transfer pricing principles.

The BC Government has stated that the BC LNG tax is not intended to apply to income from activities carried on outside of BC’s provincial boundaries.

Liquefaction activities include (but are not limited to):
- Acquiring, owning or disposing of LNG, natural gas liquids or natural gas that is at an LNG facility (or the right to acquire, own or dispose of such commodities that are at an LNG facility)
- Operating an LNG facility (including a tolling or processing fee for liquefying natural gas, regardless of whether the recipient of the fee owns the LNG facility)
- Disposing of electrical power generated at the LNG facility

The BC LNG tax is not proposed to apply to income from upstream production activities.

All aspects of the BC LNG tax are proposed to apply on a taxpayer-by-taxpayer basis, with no sharing of incentives or other amounts between project entities.

Partnerships
In the context of a partnership, the BC LNG tax applies at the partner level. A partnership’s income, losses and capital investment account amounts are allocated to its partners on an annual basis. At the end of each fiscal period, the partnership will have no income, loss or capital investment account balance for BC LNG tax purposes.

LNG tax rates
The BC LNG tax is proposed to be a two-tier tax:
- Tier 1 tax, applicable to “net operating income” (as described below), is proposed to apply at a rate of 1.5%. Tier 1 tax is creditable against Tier 2 tax.
- Tier 2 tax, applicable to “net income” (as described below), is proposed to apply at a rate of 3.5% until 2037 and 5% for taxation years thereafter. Tier 2 tax begins to apply generally after the recovery of the taxpayer’s capital investment and accumulated net operating losses.

What is taxed?
The BC LNG tax legislation distinguishes between “net operating income,” to which Tier 1 tax applies, and “net income,” to which Tier 2 tax applies.

Net operating income
“Net operating income” (to which Tier 1 tax applies) is generally the taxpayer’s profit or loss from liquefaction activities.

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the relevant year of tangible (and only tangible) LNG facility property (including land) less dispositions of such property. For purposes of the investment allowance, the adjusted capital investment account balance is not depreciated over time, such that an annual investment allowance deduction may generally be available over the life of the project.

Net operating losses from prior years cannot be applied to offset current-year net operating income (although such losses can be applied against “net income” as discussed below). Thus, Tier 1 LNG tax applies on any positive annual net operating income regardless of whether there are accumulated net operating losses from prior years.

Operating costs incurred prior to 1 January 2017 can be included in a taxpayer’s net operating loss balance.

Net income
“Net income” (to which Tier 2 tax applies) is proposed to be computed as net operating income:

- Less any accumulated net operating losses
- Less any balance remaining in the taxpayer’s “capital investment account” (described below)
- Plus any negative balance in the taxpayer’s capital investment account (i.e., resulting from dispositions of capital investment property)

The “capital investment account” is proposed to be the cumulative balance of the cost to the taxpayer of tangible LNG facility property and intangible property used for liquefaction activities. Property acquired prior to 1 January 2017 can be included in a taxpayer’s capital investment account at the beginning of its first taxation year.

Transfer pricing
The proposed LNG tax legislation includes a number of transfer pricing rules for transactions between persons not dealing at arm’s length. Unlike federal transfer pricing rules, BC LNG tax transfer pricing rules apply regardless of whether the relevant persons are resident or not resident in Canada. The transfer pricing rules include penalty provisions where the taxpayer has not made reasonable efforts to determine arm’s length transfer prices. A taxpayer is deemed not to have made reasonable efforts to determine arm’s-length prices unless specified (contemporaneous) documentation has been obtained or prepared in respect of the transactions.

The BC LNG tax legislation contains specific rules for valuing the non-arm’s-length acquisition of natural gas at the inlet to an LNG facility. Natural gas purchased from an arm’s-length person within a feedstock pipeline or at the inlet to the LNG facility is valued at the amount paid or payable for the gas from the arm’s-length person, adjusted for transportation costs. Natural gas purchased from a related party is valued by reference to a monthly Spectra Station 2 price and adjusted for the transportation cost to the LNG facility. Such transportation cost is the amount paid or payable for the service, if provided by an arm’s-length party, and is subject to transfer pricing rules in all other cases.

Natural gas credit
BC has proposed a natural gas corporate income tax credit against the current 11% corporate income tax payable in BC. The credit is proposed to equal 0.5% of the cost (or notional cost, if there is no actual transaction) of natural gas acquired by the taxpayer at the inlet to an LNG facility. The credit can be applied against tax from all of the taxpayer’s income (not just LNG income), but is limited to the amount that would bring the taxpayer’s effective BC provincial income tax rate to 8%. In order to have access to the credit, the taxpayer must have a permanent establishment in BC and must acquire (or notionally acquire) gas at the inlet to the LNG facility.

Key considerations
Consolidation
The proposed LNG tax, LNG tax incentives and the natural gas credit all apply on a non-consolidated taxpayer-by-taxpayer basis. Thus, for example, one project entity may be subject to BC LNG tax while a related project entity has significant current or accumulated net operating losses or a significant capital investment account balance remaining. While in the corporate income tax context income and loss consolidation techniques are generally accepted from a policy perspective and are widely used, it appears that such consolidation transactions could generally not be undertaken in the context of the BC LNG tax. The inability to consolidate amounts for BC LNG tax purposes among related project entities is likely to impact projects that are
structured with multiple entities for project financing or other non-tax commercial reasons.

**Ring-fenced activities and transfer pricing**

Given that the commercial structure of most BC LNG projects is expected to include multiple related project entities, transfer pricing is a critical component of determining the overall impact of the BC LNG tax. In order to ensure that only income from activities carried on in BC is subject to LNG tax, substantial analysis will be required by project proponents to identify the functions, assets and risks of each project entity in the value chain and the profits attributable to such functions, assets and risks.

The process, timing and cost of preparing documentation sufficient to support transfer prices among related parties is as yet unclear, but in any case the transfer pricing administration required by proponents is expected to be substantial. The proposed LNG tax legislation does not address whether or not a BC provincial advance pricing arrangement (APA) or similar process will be introduced.

The specific rules for valuing the acquisition of gas at the inlet to an LNG facility provide a higher degree of certainty regarding the pricing of such transactions. However, it appears that the rules may result in an understatement of the actual cost to an LNG proponent for feedstock gas, since many of the costs likely associated with long-term upstream gas contracts are not currently contemplated in the legislated rules. The specific rules for valuing the acquisition of gas at the inlet to an LNG facility will also likely mean that two transfer prices will be relevant for acquisitions of gas at the inlet to the LNG facility, one for BC LNG tax purposes and one for federal and provincial income tax purposes.

**Investment allowance rate**

The proposed LNG tax legislation does not specify the rate applicable for the investment allowance deduction in computing net operating income. It is therefore currently unclear whether the investment allowance can be considered a true proxy for financing charges relating to an LNG project. Specifying the investment allowance rate would provide additional clarity regarding the cost of the LNG tax to project proponents.

**Federal income tax considerations**

The BC LNG tax and related BC provincial income tax measure do not impact or change the application of federal income tax. Whether or not federal legislative changes will be made for the depreciation rate for tangible LNG facility equipment, the deductibility of BC LNG tax in computing federal taxable income or other matters remains uncertain.
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