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THE EVOLVING FISCAL REGIME FOR BC LNG PROJECTS: THE LNG TAX AND OTHER PROVINCIAL TAX DEVELOPMENTS

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INTRODUCTION

Liquefied natural gas ("**LNG**") exports are a rare opportunity for a major new industry in Canada, one that has already attracted some of the largest foreign inbound investment in the country's history. The massive scale of an LNG export industry would provide economic benefits to individuals and business across Canada, for decades. As of the time of writing, the National Energy Board (Canada) has approved nine LNG export licenses, mostly for proposed LNG projects on the west coast of British Columbia ("**BC**"). Certain west coast LNG projects have advanced significantly in recent months, with proponents working closely with customers, governments, lenders, engineering procurement and construction ("**EPC**") contractors, and other stakeholders to address the many complex issues associated with project development.

However, the outlook for west coast LNG projects has changed dramatically over the last two years. Proponents continue to grapple with significant challenges, including intense competition from faster moving, lower cost LNG projects in the United States; immense greenfield costs for facilities, pipelines and related infrastructure; ongoing complex environmental and other regulatory processes and First Nations consultations; labour force uncertainties; and the high cost of the combined federal, provincial and municipal tax take. With Canada still awaiting its first final investment decision ("**FID**") for an LNG export project, a large scale LNG industry in western Canada is, at this time, far from certain.

In October 2014, the BC government released *Bill 6 – 2014: Liquefied Natural Gas Income Tax Act* ("**Bill 6**") and *Bill 2 – 2014: Greenhouse Gas Industrial Reporting and Control Act* ("**Bill 2**" or the "**GGIR**"), both of which received royal assent on November 27, 2014.[1] Bill 6 introduced legislation (the "**LNG Act**") for a new BC provincial income tax on natural gas liquefaction activities (the "**LNG Tax**"), as well as a related BC provincial corporate income tax credit (the "**Gas Credit**"). In recognition of Canada's challenges in competing in the global LNG industry, Bill 6 included a number of substantial revisions from BC's initial February 2014 Budget proposals for the LNG Tax to make the tax less costly for proponents, including a reduction of the tier two tax rate and the introduction of the Gas Credit. Bill 2 addresses the management of greenhouse gas emissions from the point when gas enters a facility to where it is loaded on to ship or rail for market. The GGIR is in addition to the BC carbon tax introduced in 2008, which is a broad-based tax that applies to the use of fossil fuels in BC; the BC provincial sales tax ("**PST**") introduced in the spring of 2013; and other provincial taxes.

The purpose of this article is to provide an overview of the recently introduced LNG Tax, Gas Credit, and GGIR and some of the related key issues and uncertainties critical to proponents at this stage of BC's emerging LNG industry. The article also addresses the BC carbon tax and PST as applicable in respect of proposed LNG processing and export activities in BC. Part A discusses the LNG Act, Part B the Gas Credit, and Part C the GGIR, PST, and carbon tax.

As proponents continue to work with the BC government on the details of the LNG Tax, it is anticipated that amendments to the existing legislation will be proposed in 2015. Separate regulations addressing administrative, compliance and other matters relating to the LNG Tax (the "**LNG Regulations**") and the GGIR (the "**GGIR Regulations**")

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are also expected to be released in draft form in early 2015. This article does not address the implications of potential amendments to the LNG Act, the Gas Credit, or other legislation, nor does it address the impact of the LNG Regulations or GGIR Regulations yet to be released.

All statutory references in this article are to the LNG Act, unless otherwise specified.

PART A – LNG ACT

Overview of the LNG Act

LNG Tax is a new BC provincial income tax separate from the federal *Income Tax Act*[2] (the "**federal ITA**") and *Income Tax Regulations* (the "**federal Regulations**") and the BC provincial *Income Tax Act*[3] (the "**BC ITA**"). LNG Tax applies for taxation years beginning on or after January 1, 2017 to profits from an "LNG source", which is defined as "liquefaction activities" carried out at or in respect of a particular LNG facility in BC.[4] The LNG Act distinguishes not only between an LNG source and a non-LNG source, but also between each particular LNG source. Thus, if a person has an LNG source and a non-LNG source, LNG Tax applies only to income from the LNG source; and if the person has more than one LNG source (i.e. the person undertakes liquefaction activities at or in respect of more than one LNG facility), LNG Tax applies separately on a non-consolidated basis to each LNG source.

Conceptually, LNG Tax applies only to a ring-fenced set of activities, from the input of feed gas to an LNG facility to the sale of LNG from the BC coast. If there is no actual transaction at these boundaries, sales or purchases (as applicable) are deemed to occur at amounts determined in accordance with specific transfer pricing rules as described under the heading "Transfer Pricing Considerations" below.

Only a "taxpayer" is liable for LNG Tax.[5] A "taxpayer" is defined for purposes of the LNG Act as "a person who engages in or has income derived from liquefaction activities, whether or not the person is liable to pay tax under [the LNG Act]".[6] A person for these purposes includes an individual, a corporation and a trust, whether or not resident in Canada, and regardless of whether the person has a permanent establishment in Canada.[7] Certain persons exempt from federal income tax are also exempt from LNG Tax.[8]

A taxpayer for LNG Tax purposes does not include a partnership.[9] However, the LNG Act contains specific rules that apply where a taxpayer is a member of a partnership that engages in, or has income derived from, liquefaction activities in respect of an LNG source. These rules are summarized under the heading "Partnerships under the LNG Act" below.

The LNG Tax is a two tier tax. A tier one tax of 1.5% applies to an LNG taxpayer's "net operating income".[10] A tier two tax of 3.5% (5% for taxation years beginning on or after January 1, 2037) applies to an LNG taxpayer's "net income".[11] The computation of "net operating income" and "net income" is described further below. Tier one tax is creditable against tier two tax, such that the maximum aggregate LNG Tax payable will be at the tier two tax rate. LNG Tax is not deductible for federal or provincial income tax purposes under current legislation.

Liquefaction Activities

The definition of "liquefaction activities" is fundamental for determining which persons are subject to LNG Tax and the profits to which LNG Tax applies. "Liquefaction activities" is defined as one or more of the following:[12]

a) Acquiring, owning or disposing of LNG, natural gas liquids or natural gas that is at an LNG facility in BC, or a right to such activities;

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b) Acquiring, owning or disposing of all or part of an LNG facility in BC or a right to use all of part of an LNG facility in BC;

c) Operating all or part of an LNG facility in BC (regardless of whether the taxpayer owns the facility);

d) In relation to a person who owns or operates all or part of an LNG facility in BC, the disposition of electrical power generated at the facility;

e) In relation to a person who owns or operates all or part of an LNG facility in BC, acquiring, owning or disposing of intangible personal property that is, generally, used for the operations of the facility;

f) Acquiring, owning or disposing of a right to receive income derived from one or more of the activities in (a) to (e) above;

g) In relation to a person who undertakes one or more of the activities in (a) to (f) above, activities that support the construction, administration, operations and maintenance of an LNG plant in BC; and

h) Restoring, reclaiming or remediating an LNG facility site.

The activities referred to in paragraphs (d), (e) and (g) apply "in relation to a person" who acquires, owns or disposes of a commodity at the LNG facility or the facility itself, or owns or operates an LNG facility (or has a related right). It is not clear whether the phrase "in relation to a person" is intended to restrict the activities described in paragraphs (d), (e) and (g) to a person that also acquires, owns, or disposes of a relevant commodity or owns or operates any part of the facility (or has a right to do so); or whether the activities described in paragraphs (d), (e) and (g) are liquefaction activities even if the person carrying on such activities does so merely in relation to another person that carries on the acquisition, ownership, disposition, or operation activities. Under the former interpretation, a person, such as a third party service provider performing maintenance activities at the LNG facility, may not be an LNG taxpayer provided the person does not itself acquire, own, or dispose of a relevant commodity or own or operate any part of the facility. Under the latter interpretation, the breadth of the LNG Act would potentially be far greater. Our understanding is that the former interpretation is correct, in part due to informal discussions with the BC government in which officials have stated that LNG Tax is not intended to apply to, for example, a facility EPC contractor (provided the contractor never owns or operates any part of the LNG facility). However, it remains unclear how the phrase "in relation to a person" may be interpreted by administrators of the LNG Tax.

Careful planning is necessary to ensure a person does not inadvertently become an LNG taxpayer by virtue of carrying on a liquefaction activity. An example of a presumably unintended application of the LNG Act is to a third party pipeline operator that enters into a capacity agreement for the transportation of natural gas to an LNG facility, which is delivered to the LNG processor immediately after the LNG facility inlet meter owned by the pipeline operator. Based on the definition of an "LNG facility", which includes (by reference to the definition of "LNG plant") property used for receiving or measuring natural gas delivered to the facility, the pipeline operator could potentially be operating part of an LNG facility and therefore engaging in liquefaction activities.[13] Although the pipeline operator's profits associated with such activities may be minimal, the pipeline operator may nevertheless be subject to administrative and compliance obligations associated with the LNG Act.

A similar issue may arise where a third party upstream producer disposes of natural gas to an LNG processor/exporter at a point that is already within the LNG facility. However, it may be advantageous in certain circumstances for an upstream producer to be an LNG taxpayer, as described in the context of the Gas Credit in Part B below.

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Application to Non-residents

The LNG Act does not distinguish between residents and non-residents of Canada. Profits from liquefaction activities may be subject to LNG Tax regardless of the jurisdiction of residence of the person that carries on the activities or whether such person has a permanent establishment in BC.[14] BC has been clear that income tax treaties between Canada and foreign jurisdictions, including the permanent establishment and business profits articles of such treaties, will not apply to limit the scope of the LNG Act.[15]

Whether LNG Tax imposed on a non-resident may be offset with a foreign tax credit will depend on the double taxation provisions of a relevant treaty (if any), the foreign tax credit rules in the foreign jurisdiction (if any), and the non-resident's tax rate in the foreign jurisdiction. If no foreign tax credit is available, LNG Tax will represent a pure additional cost to the non-resident undertaking liquefaction activities. In addition to the potential BC LNG Tax cost, the application of LNG Tax to non-residents will impose an administrative and compliance burden, including potentially onerous transfer pricing requirements, on a non-resident undertaking liquefaction activities. This is the case even if the non-resident does not have a physical presence in Canada or is not carrying on business in Canada for federal income tax purposes.

Refer to "Transfer Pricing Considerations" below for further discussion of the computation of a non-resident's profits for LNG Tax purposes.

Capital Investment Account and Adjusted Capital Investment Account

The LNG Act distinguishes between a taxpayer's "capital investment account" ("**CIA**") and its "adjusted capital investment account" ("**Adjusted CIA**"). A taxpayer's CIA is relevant in computing the taxpayer's net income from an LNG source subject to tier two tax (discussed under the heading "Net Income" below).[16] A taxpayer's Adjusted CIA is relevant for determining a taxpayer's investment allowance in computing net operating income from an LNG source (discussed under the heading "Net Operating Income or Loss" below).[17]

Capital Investment Account

A taxpayer is not entitled to deduct depreciation for LNG Tax purposes. However, a taxpayer is entitled to deduct up to the full amount of its CIA balance in computing net income subject to tier two tax. Thus, an LNG taxpayer should not be subject to tier two tax on income from an LNG source until such time that the taxpayer has claimed the full amount of its CIA balance for that source.

A taxpayer's CIA balance at a particular time for an LNG source is computed as:

the total of:[18]

- the cumulative cost of "capital investment property" acquired by the taxpayer before that time, excluding any financing charges or amounts in respect of hedging transactions;[19]
- any recaptured CIA balance (if the CIA balance becomes negative because of dispositions of capital investment property); and
- the amount of certain payments in respect of financial incentives, countervailing or anti-dumping duties, and bad debts;

less the total of:[20]

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- the proceeds from dispositions of "capital investment property" (less any expenses of disposition);
- deductions from the CIA in computing the taxpayer's net income (as described under the heading "Net Income" below); and
- the amount of certain receipts in respect of financial incentives, countervailing or anti-dumping duties, and bad debts.

"Capital investment property" is defined as, generally, "tangible personal property" that comprises the LNG facility (including land and improvements to the land) and "intangible personal property" that is used or exploited for liquefaction activities carried out at or in respect of an LNG facility".[21] Capital investment property is also deemed to include the cost of leasehold interests.[22]

The LNG Act does not contain a definition of either "tangible personal property" or "intangible personal property". Based on informal discussions with the BC government, we understand that tangible personal property for purposes of the CIA is intended to include, generally, any property (comprising the LNG facility) that is described in a capital cost allowance class for federal income tax purposes, plus land and improvements to such land. "Intangible personal property" would presumably include the cost of rights to use information or processes in the construction of the facility and other costs that would be eligible capital expenditures for federal income tax purposes.

Since the LNG Act must, in case of doubt, "be applied and interpreted in a manner consistent with similar provisions of the [federal ITA]",[23] the calculation of a taxpayer's cost of tangible and intangible personal property for LNG Tax purposes should generally be undertaken on the same basis as it would be for federal income tax purposes, except as otherwise specified under the definition of the CIA. The cost of capital investment property for an LNG facility should therefore include, for example, engineering and labour costs directly related to the construction of the LNG facility. Other pre-FID costs, including amounts paid for market research, feasibility studies, legal services, preliminary engineering and design, site investigation, and other costs not directly linked to the construction of the LNG facility, may be included in a taxpayer's net operating loss balance (subject to the elective provisions discussed under the heading "Net Operating Income or Loss" below) and not included in the taxpayer's CIA balance.

Capital Investment Property Acquired Prior to the Taxpayer's First Taxation Year

Capital investment property acquired by a taxpayer prior to its first taxation year (beginning not sooner than January 1, 2017) and owned immediately prior to such taxation year may be included in the taxpayer's CIA balance, provided the taxpayer files an election within 18 months after the end of the taxpayer's first taxation year as described in the LNG Act.[24] If an election is filed, the taxpayer will add to its CIA the fair market value of the property at the beginning of the taxpayer's first taxation year. Alternatively, the taxpayer may file an election to include in its CIA the original cost of the property less any financial incentives received by the taxpayer before the first taxation year in respective of the property. If the taxpayer chooses the fair market value method, the taxpayer must deduct from the fair market value of the property any amounts incurred prior to its first taxation year and elected to be included in the taxpayer's opening net operating loss balance (as described under the heading "Net Operating Income or Loss" below).

A person will not have a CIA balance until the person becomes an LNG taxpayer. Pursuant to the definitions of "LNG taxpayer" and "liquefaction activities" summarized above, it appears that a person would not be an LNG taxpayer until construction has commenced on the relevant LNG plant. Based on informal discussions with the BC government officials, it is understood that the cost of capital investment property acquired before the time a person becomes an LNG taxpayer is intended to be included in the taxpayer's CIA, provided the taxpayer makes the election described above.

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Adjusted Capital Investment Account

A taxpayer's Adjusted CIA for an LNG source (relevant for computing the taxpayer's investment allowance) is essentially the taxpayer's CIA balance, prior to any deductions claimed from the CIA in computing net income.[25] Thus, a taxpayer may have an Adjusted CIA balance even if its CIA balance has been reduced to zero. A taxpayer's Adjusted CIA also excludes the cost of intangible personal property.

Net Operating Income or Loss

A taxpayer's "net operating income" (to which tier one tax applies) or "net operating loss" for a taxation year from an LNG source is computed generally as the taxpayer's income or loss for the taxation year from a business or property that is in respect of the LNG source (excluding income and deductions not relating to that source).[26] Income or loss from a business or property for LNG Tax purposes is computed in a manner similar to the computation of income or loss for federal income tax purposes, with certain key differences, including the following:[27]

- There is no income inclusion for interest or dividends;[28]
- There is no deduction for financing charges, including interest, debt issuance costs, guarantee fees, and other financing costs;[29]
- There is no income inclusion or deduction for gains or losses from foreign exchange fluctuations on long-term debt;[30]
- There is no income inclusion or deduction for hedging transactions;[31]
- There is no deduction for capital cost allowance and no income inclusion for recaptured capital cost allowance (but refer to the adjustments relating to the CIA for the computation of "net income" below);[32] and
- There is no income inclusion or deduction for gains or losses from the disposition of capital investment property (other than if the CIA balance becomes negative, as described for the computation of "net income" below).[33]

Investment Allowance

Although financing charges are not deductible for LNG Tax purposes, an annual "investment allowance" is deductible in computing net operating income. The investment allowance is computed as the prescribed rate (to be set out in the LNG Regulations) multiplied by 75% of the taxpayer's Adjusted CIA balance. Since the Adjusted CIA balance is not reduced by claims from the CIA in computing net income, a taxpayer may be entitled to an annual investment allowance deduction over the life of the LNG project.[34]

While the investment allowance appears to be a notional deduction permitted in lieu of a deduction of all or part of the actual financing costs that may be incurred by a taxpayer to finance the capital cost of an LNG facility, because the investment allowance is based only on a taxpayer's Adjusted CIA balance, there is no investment allowance relating to any financing costs incurred to finance working capital or net operating losses. Further, depending on the prescribed rate to be set out in the LNG Regulations, the investment allowance may be significantly less than the actual financing costs incurred to finance the cost of the LNG facility.

Net Operating Losses

Prior year net operating losses from an LNG source cannot be applied to offset current year net operating income (although such losses can be applied against "net income" from the LNG source as discussed below). Thus, tier one LNG

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tax applies on any positive annual net operating income from an LNG source regardless of whether there are accumulated net operating losses from prior years or net operating losses from another LNG source.

A taxpayer's operating costs relating to an LNG source incurred prior to the taxpayer's first taxation year (beginning not before January 1, 2017) can be included in the taxpayer's net operating loss balance for the LNG source, provided the taxpayer files an election within 18 months after the end of the taxpayer's first taxation beginning on or after January 1, 2017. We understand that the legislator's intention is that qualifying expenditures for purposes of the election include costs incurred prior to commencement of construction of the LNG facility (on an elective basis), provided the expenditures were incurred "for the purpose of gaining or producing income from an LNG source".[35]

Net Income

A taxpayer's "net income" for a taxation year from an LNG source (to which tier two tax applies) is computed as the taxpayer's net operating income, with the following adjustments:

- The taxpayer must add any negative CIA balance for the LNG source (i.e., resulting from dispositions of capital investment property in excess of the net balance of the CIA);[36]

- To the extent of any positive net income, the taxpayer must deduct accumulated prior year net operation losses from the LNG source in computing net income, prior to any CIA claims;[37] and

- To the extent of any remaining positive net income, the taxpayer must deduct an amount from its CIA up to the remaining balance in the account.[38]

Any remaining positive net income from an LNG source is subject to tier two tax.

Closure Tax Credit

The LNG Act provides for an LNG Tax credit for a taxpayer's last taxation year in respect of an LNG source for certain expenditures required to comply with an obligation to restore, reclaim or remediate the LNG facility site.[39] The credit is available only once the taxpayer files notification of an intention to permanently cease operations at the relevant LNG facility. The credit is refundable up to the amount of net LNG tax paid in prior years (i.e. the taxpayer need not have LNG tax payable in the year the credit is claimed in order to benefit from the credit).[40] The taxpayer must file for the credit within 18 months after the end of its last taxation year (as defined).[41]

Partnerships under the LNG Act

A partnership is not a taxpayer for LNG Tax purposes. However, similar to the rules relating to partnerships under the federal ITA, an LNG taxpayer that is a member of a partnership that engages in, or has income derived from, liquefaction activities is required to compute the following amounts as if the partnership were a separate person:[42]

- The taxpayer's income or loss for a taxation year from a business or property;

- The balance of the taxpayer's CIA and Adjusted CIA; and

- For the purposes of the closure tax credit (as summarized above), the taxpayer's eligible expenditures for the taxpayer's last taxation year in respect of the LNG source.

A member of the partnership is then required to include its share of the partnership's income or loss in computing the member's income or loss for the taxation year in which the partnership's fiscal period ends.[43]

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The LNG Act incorporates the anti-partnership deferral rules in section 34.2 of the federal ITA,[44] and has its own internal anti-avoidance rules for unreasonable partnership allocations similar to the rules in section 103 of the federal ITA.[45]

Capital Investment Property Acquired by a Partnership

The computation of a partnership's CIA balance is undertaken on an annual basis, with the opening balance of the account being zero at the beginning of each year.[46] If the balance of the partnership's CIA balance is positive at the end of its fiscal period, a member of the partnership is deemed to have acquired capital investment property at the end of the partnership's fiscal period in an amount equal to the member's share of the partnership's CIA balance;[47] and if the balance of the partnership's CIA balance is negative, the member is deemed to have disposed of capital investment property at the end of the partnership's fiscal period in an amount equal to the member's share of the CIA balance.[48]

A partnership is also required to compute its Adjusted CIA balance.[49] However, there is no provision that deems a member of the partnership to have acquired capital investment property for purposes of the taxpayer claiming an investment allowance. It appears that such a deeming provision is not necessary, since once the taxpayer is deemed to have acquired its share of the partnership's capital investment property, the taxpayer's Adjusted CIA could be determined in accordance with rules for the computation of the investment allowance.[50] However, if a taxpayer's investment allowance is determined in this manner, it is not clear why a partnership should be required to compute its Adjusted CIA balance.

An additional uncertainty relating to capital investment property acquired through a partnership arises from the rules for the acquisition of a partnership interest. A taxpayer that purchases an interest in a partnership at a particular time is deemed to have acquired capital investment property at that time in an amount equal to the taxpayer's share of the fair market value of the partnership's capital investment property at that time.[51] However, the taxpayer is also deemed to have acquired its share of the partnership's capital investment property at the end of the partnership's fiscal period in accordance with the rules described above. There appears therefore to be the potential for a double counting of the cost of capital investment property in certain circumstances in a year in which a taxpayer acquires an interest in a partnership. This would clearly be an unintended result.

Tiered Partnerships

The LNG Act provides that a reference to a person or taxpayer who is a member of a particular partnership includes a reference to another partnership that is a member of the particular partnership.[52] Accordingly, the rules summarized above for computing the income or loss, CIA balance, and Adjusted CIA balance of a member of a partnership also apply to multi-tier partnership structures. The transfer pricing rules discussed below also accommodate tiered partnerships.[53]

Transfer Pricing Considerations

Determining arm's length transfer prices is one of the most critical aspects of an LNG project, and, unfortunately, one of the most complex. The LNG Act includes transfer pricing rules applicable to transactions between persons not dealing at arm's length. The transfer pricing rules in the LNG Act are in many respects similar to those in the federal ITA. Backgrounder documents to the LNG Act also endorse the transfer pricing guidelines published by the Organization for Economic Cooperation and Development (the "**OECD Transfer Pricing Guidelines**").

The transfer pricing rules in the LNG Act permit amounts to be adjusted to the quantum or nature of the amounts that would have been determined if, (a) where the terms or conditions between the participants differ from those that would have been made between persons dealing at arm's length, such arm's length terms or conditions;[54] or (b), where the transaction or series of transactions would not have been entered into between persons dealing at arm's length and can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax

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benefit, the transaction or series had been the transaction or series that would have been entered into between persons dealing at arm's length.[55] These provisions mirror those contained in section 247 of the federal ITA.

The transfer pricing rules in the LNG Act include penalty provisions where the taxpayer has not made reasonable efforts to determine arm's-length transfer prices.[56] 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.[57]

Unlike the transfer pricing rules in the federal ITA, the transfer pricing rules in the LNG Act apply regardless of whether the relevant persons are resident or non-resident. Thus, the transfer pricing rules in the LNG Act may, depending on the project structure, represent significant additional administrative burdens on project proponents (in addition to transfer pricing requirements for federal income tax purposes).

Consistent with the intent of the LNG Act to tax only activities occurring from the entrance of natural gas to the LNG facility to the export of LNG from BC, the LNG Act includes deemed cost of gas rules for natural gas owned immediately before and after an LNG facility inlet meter, and deemed disposition rules for LNG owned immediately before and after the LNG plant. Each of these sets of rules is discussed below.

The transfer pricing rules in the LNG Act also contain self-dealing provisions. These provisions apply where a taxpayer has dealings between activities in respect of an LNG source and a non-LNG source, or between activities in respect of multiple LNG sources. The self-dealing rules deem the taxpayer to be a separate non-arm's length person in respect of each of the sources, and the dealings are deemed to be transactions between the hypothetical persons subject to the general transfer pricing rules in the LNG Act.

Deemed Cost of Natural Gas

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. The implications of the rules depend on where the natural gas is purchased and whether or not the purchaser and vendor act at arm's length.

- If a taxpayer owns natural gas both immediately before and after the natural gas passes through an "LNG facility inlet meter", the taxpayer's cost of the natural gas for LNG Tax purposes is computed in accordance with the rules described below.[58] This is the case regardless of whether the taxpayer acquires the natural gas before the LNG facility inlet meter or itself produces the natural gas. This is also the case regardless of whether the natural gas is acquired (before the LNG facility inlet meter) from an arm's length or non-arm's length person or partnership. However, as noted in the discussion of the computational rules described below, if the taxpayer acquires natural gas from an arm' s length person while the natural gas is in a feedstock pipeline, the cost of the natural gas will effectively be adjusted to the amount paid or payable for the gas.

- If the taxpayer acquires natural gas at the LNG facility inlet meter from a person or partnership with which the taxpayer was dealing at arm's length, the taxpayer's cost of the natural gas is the amount paid or payable for the gas.

- If the taxpayer acquires natural gas at the LNG facility inlet meter from a person or partnership with which the taxpayer was not dealing at arm's length, the taxpayer's cost of the natural gas is computed in accordance with the rules described below.[59]

- If the taxpayer acquires natural gas after the LNG facility inlet meter from a person or partnership with which the taxpayer was dealing at arm's length, the taxpayer's cost of the natural gas is determined as the amount paid or payable for the gas. However, in this case, the vendor of the natural gas would also be an LNG taxpayer, because

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the vendor would be disposing of the gas at an LNG facility. The vendor would also be subject to the deemed cost of gas rules for natural gas owned both before and after the LNG facility inlet meter.

- If the taxpayer acquires natural gas after the LNG facility inlet meter from a person or partnership with which the taxpayer was not dealing at arm's length, the taxpayer's cost of the natural gas is determined in accordance with the general transfer pricing rules for transactions between parties not dealing at arm's length. However, again, the vendor of the natural gas would be an LNG taxpayer and would be subject to the deemed cost of gas rules for natural gas owned both before and after the LNG facility inlet meter.

Where the deemed cost of natural gas rules apply, the taxpayer must calculate, for each month in the taxation year, the cost of the natural gas as the total of:[60]

(a) The value of the gas based on a reference price (see discussion below);[61]

(b) In the case where the taxpayer acquired the natural gas from a person or partnership with which the taxpayer was dealing at arm's length while the natural gas was in a feedstock pipeline, a positive or negative amount that effectively adjusts the cost of the natural gas to the amount actually paid or payable for the natural gas;[62] and

(c) The taxpayer's actual delivery cost for the natural gas, which amount is subject to the general transfer pricing rules in the LNG Act if paid to a person or partnership with whom the taxpayer does not deal at arm's length.[63]

Regarding the reference price for the deemed cost of gas in (a) above, the government of BC stated in a backgrounder document to the LNG Act that the price would be determined using the market price of natural gas at Spectra Station 2. However, such reference price is not specified in the LNG Act itself. It is our understanding that the reference price will be specified in the LNG Regulations, and that, based on informal discussions with the BC government, may be determined using a market index other than Spectra Station 2 or a market index that may depend on the taxpayer's circumstances.

The definition of an "LNG facility inlet meter", and the fact that an LNG facility inlet meter does not necessarily coincide with the border of an LNG facility, causes uncertainty in the interpretation of the legislation as enacted. An "LNG facility inlet meter" is defined as "the meter on a feedstock spur pipeline at which the volume of natural gas is first measured after the natural gas is delivered to an LNG facility".[64] A "feedstock spur pipeline" is defined in turn as a natural gas pipeline that delivers natural gas from a feedstock pipeline to the series of systems used for liquefying natural gas.[65] In the case where a dedicated pipeline delivers natural gas directly to an LNG facility, there may not be a feedstock spur pipeline on which a meter is located. In this case, it is assumed, although not clear, that the determination point for the deemed cost of gas rules would nevertheless be an inlet meter located either on the main feedstock pipeline or within the LNG facility.

In any case, the location of the LNG facility inlet meter will not necessarily coincide with the start of the LNG facility as defined in the LNG Act. For example, the definition of an "LNG facility" includes property used for delivering gas to the series of systems used for liquefying natural gas by means of a feedstock spur pipeline,[66] which suggests that, where there is a feedstock pipeline, the inlet meter will necessarily be already within the facility. The implication is that if, for example, an upstream producer disposes of natural gas at the LNG facility inlet meter, such disposition may be occurring already within the LNG facility, such that the vendor would be an LNG taxpayer. Careful consideration of the relevant transactions (including the transfer point for natural gas) must be undertaken to ensure adverse LNG Tax consequences do not inadvertently arise for project proponents.

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Sales of LNG

Where a taxpayer owns LNG immediately before and after the LNG leaves an “LNG plant”, the taxpayer is deemed to have disposed of the LNG when it leaves the LNG plant in a transaction with a person with whom the taxpayer does not deal at arm’s length for the amount that would have been the price if the disposition had been made to a person with which the taxpayer was dealing at arm’s length.[67]

The deemed sale of LNG rules pose conceptual challenges in applying transfer pricing principles. Since the deemed LNG sale transaction is not between actual separate persons, it is unclear how the functions, assets and risks of each hypothetical person are to be determined. The allocation is particularly problematic where the taxpayer is a non-resident of Canada and has functions, assets and risks related both to liquefaction activities in Canada and activities (such as marketing or trading activities) outside of Canada. The allocation of functions, assets and risks could presumably impact the deemed sale price for LNG, and as a consequence the taxpayer’s income subject to LNG Tax.

One must further consider whether a sale of LNG subsequent to the LNG leaving the LNG plant may also be subject to the application of the LNG Act. In particular, the definition of an “LNG facility” is broader than the definition of an “LNG plant” and includes land subjacent to the LNG plant and land contiguous to such land (including land covered by water).[68] A taxpayer that disposes of LNG after it leaves an “LNG plant” but while the LNG is still at the “LNG facility” (for example, in waters immediately beyond the loading dock) may be subject to LNG Tax in respect of both the deemed sale of LNG as it leaves the LNG plant and the actual sale of LNG. Similarly, a person that both acquires and disposes of LNG after the LNG plant but within the LNG facility may be subject to LNG Tax, where the transactions would be outside of the LNG Act if they occurred after the LNG facility. The implications of multiple deemed and actual sales of LNG can potentially be highly adverse depending on the circumstances.

We understand that the government of BC may be considering amendments to the LNG Act in order for the exit point of an LNG facility to be made consistent with the exit point for an LNG plant.

Other Transfer Pricing Considerations

An appropriate transfer pricing methodology in any particular circumstance will depend on a detailed analysis of the entire value chain, including the nature of the transactions undertaken, the allocation of functions, assets and risks between the parties throughout the value chain, the availability of arm’s length market data, and other factors. Given the similarities of the transfer pricing rules in the LNG Act with those in the federal ITA, as well as BC’s endorsement of the OECD Transfer Pricing Guidelines, a taxpayer’s choice of transfer pricing methodologies for LNG tax purposes will likely be similar to those for federal income tax purposes. However, a transfer pricing analysis for LNG Tax purposes may provide different results than for federal income tax purposes, particularly in the context of the self-dealing rules in the LNG Act.

The future evolution of the LNG industry, including the development of comparable transactions in North America and other jurisdictions and increased liquidity in the trading of LNG generally, may impact the determination of appropriate transfer pricing methodologies as proponents move closer to production. Because of the significant impact of transfer pricing on project economics, proponents are seeking certainty regarding transfer pricing methodologies in determining the viability of proposed projects. Although the LNG Act itself does not address the potential for an advance pricing arrangement (“**APA**”) for LNG Tax purposes, the BC government has indicated informally that an APA program is intended to be made available. We understand that the process for a BC APA, the extent to which a provincial APA may be based on a federal APA, and how soon a provincial APA may be able to be obtained, are all matters that are still being addressed by the legislator and BC administrators.

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Consolidation, Amalgamations, and Transfers of Property

Apart from specific amalgamation provisions, the LNG Act does not allow for consolidation for LNG Tax purposes, nor does it contemplate tax deferred reorganizations or tax free transfers of property. Accordingly, taxpayers should ensure to the extent possible that an optimal project structure is implemented at the start of a project (or undertake any necessary reorganization transactions prior to January 1, 2017) to minimize adverse consequences of future changes. More detailed considerations relating to consolidation, amalgamations and transfers of property are discussed below.

Consolidation

Each LNG taxpayer must report its activities and pay LNG Tax on a legal entity basis. Further, since financing income and expenses (including interest) are generally excluded from the computation of net operating profit and loss for LNG Tax purposes, many of the loss consolidation transactions commonly undertaken for federal and provincial income tax purposes will not be effective for LNG Tax purposes.

The lack of tax consolidation under the LNG Act can lead to an acceleration of the amount of LNG Tax payable within a related group. LNG Tax leakage will arise (at least on a present value basis) where an LNG taxpayer has net income for LNG Tax purposes while a related entity has not yet fully claimed its CIA balance and/or net operating losses. For example, if one Canadian company within the project structure (the "commodity owner") owns the commodity through the liquefaction process and realizes profits from sales of LNG while another Canadian company (the "facility owner") owns and operates the LNG facility on a tolling basis, then the commodity owner may have positive net income for LNG tax purposes (subject to 3.5% LNG tax) while the facility owner has a substantial CIA balance remaining and is subject to not more than a 1.5% LNG tax.

Nevertheless, there are structuring options that can achieve informal consolidation for LNG Tax purposes. An obvious solution is to have a single Canadian entity undertake all the liquefaction activities, including the ownership of the commodity and the ownership and operation of the LNG facility. However, a single entity structure may not be possible for several reasons, including obtaining project financing for the facility construction (which may require the ownership of the facility in a separate entity) or joint investment in the project by multiple participants.

An equally effective solution for consolidation may be to undertake the LNG project activities through one or more limited partnerships. An example of a partnership structure is described in Part B below in the context of access to the Gas Credit. However, having a non-resident as a member of the partnership is generally not advisable, as such a structure would cause the partnership not to be a "Canadian partnership" and would potentially cause the non-resident to have a permanent establishment in Canada. Thus, there may be no practical options for consolidating net income of a non-resident for LNG Tax purposes with that of related Canadian entities. Nevertheless, it may still be more advantageous from an income tax perspective (and a tax perspective overall) for a non-resident to carry on certain liquefaction activities, provide such activities are consistent with the commercial structure of the project.

Amalgamations

Although the LNG Act does not permit consolidated tax reporting, the LNG Act does provide for a tax-deferred amalgamation of LNG taxpayers that are taxable Canadian corporations. Where the required conditions are met,[69] the new corporation is deemed to be the same corporation as, and a continuation of, each predecessor corporation for purposes of, among other things, computing the balance of the new corporation's CIA for an LNG source and claiming the closure tax credit.[70] The predecessor corporations' net operating loss account balances are aggregated to form the amalgamated corporation's net operating loss account balance,[71] and the predecessor corporations' cost of inventory is generally flowed through to the amalgamated corporation.[72] As with the LNG Act generally, the amalgamation rules apply on a source by source basis.[73]

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There are no provisions in the LNG Act that permit a tax deferred winding-up of a corporation or any other tax deferred reorganization (other than an amalgamation).

Taxable Transfers of Property

Unlike the federal ITA, The LNG Act does not provide for tax deferred transfers of property. A disposition of capital investment property occurs at fair market value, and is subject to the transfer pricing rules where the transfer occurs between persons that do not act at arm's length. The vendor's proceeds of disposition for the capital investment property reduce the vendor's CIA account, and any excess is included in net income for LNG tax purposes and may give rise to an immediately LNG Tax liability.[74] The purchaser's cost of the capital investment property is added to the purchaser's CIA account balance.[75]

The disposition of property to a partnership by a member thereof or to a trust and the disposition of property by a partnership to a member thereof or by a trust are specifically deemed to occur at fair market value.[76]

Accounting and Reporting Matters

LNG Tax applies only in respect of an LNG source, and separately to each LNG source. Thus, if a taxpayer has activities from an LNG source and non-LNG source, and/or activities from multiple LNG sources, the taxpayer's accounting, tax and other systems will need to be designed to track and report amounts on a source by source basis. Taxpayers will also need to track pre-2017 operating and capital expenditures (if any) for which an election may be made for purposes of the taxpayer's opening CIA and net operating loss balances.

In the case where a taxpayer incurs pre-FID LNG project related expenditures but does not ultimately proceed with the project, consideration must be given to the characterization of the pre-FID costs for income tax purposes. Particular costs could potentially be fully deductible on a current basis, capital (for example, costs of eligible capital property), or "nothings", depending on the circumstances and the nature of the costs.

It is anticipated that the LNG Regulations, when released, will provide guidance regarding administrative reporting matters for LNG Tax purposes.

PART B – NATURAL GAS CREDIT

Contained in Bill 6 is a non-refundable BC provincial corporate income tax credit measure for natural gas acquired or notionally acquired at an LNG facility. Although the credit is contained in the BC ITA rather than the LNG Act, the credit, if available, represents a significant offset to the cost of the LNG Tax. The credit is effective for taxation years beginning on or after January 1, 2017 (coinciding with the application of the LNG Act).

Entitlement to the Gas Credit

The Gas Credit is available to a "qualifying corporation", being a corporation that is an LNG taxpayer (i.e., a corporation that, either itself or through a partnership, engages in or has income derived from "liquefaction activities" as defined in the LNG Act) and that has a permanent establishment in BC for provincial income tax purposes.[77] The credit is computed by reference to natural gas acquired or notionally acquired by the corporation (or a partnership of which the corporation is a member) at the "LNG facility inlet meter" for an LNG facility, and is subject to other limitations (refer to the discussion under the heading "Computation of the Credit" below). In order to benefit from the credit, the corporation must have profits allocated to BC that generate a BC income liability against which the credit can be applied.

As a provincial income tax incentive, the Gas Credit encourages LNG taxpayers to undertake activities in BC, as opposed to another province or outside of Canada. For taxpayers that would otherwise undertake the relevant activities outside

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of BC, it is important to consider both the tax and non-tax consequences of altering the project structure or transactions to obtain access to the credit. In certain cases, it may be beneficial from a tax perspective to shift activities to BC that would otherwise be undertaken in another province, if by doing so the related income would be taxed at a lower effective provincial tax rate (due to the benefit of the Gas Credit). A greater allocation of taxable income to BC could be achieved, for example, by moving employees to BC from another province.[78] Shifting activities to BC that would otherwise be undertaken outside of Canada by a non-resident that does not have a permanent establishment in Canada would likely not be beneficial to the extent the change exposes the non-resident to incremental Canadian federal and provincial income tax.

As with LNG Tax, the Gas Credit applies on a non-consolidated basis. If project activities are undertaken in separate entities, there may be a mismatch between the entity eligible to claim the credit (e.g., the entity acquiring or notionally acquiring natural gas at the LNG facility inlet meter) and other entities that are generating taxable income allocated to BC. An example is a tolling model in which an Alberta company (the “commodity owner”) produces or acquires feedstock gas and engages a separate company in BC (the “facility owner”) that owns the LNG facility and processes the natural gas. The commodity owner then sells the LNG to customers for export. In this case, the only company that could potentially access the Gas Credit is the commodity owner, since the commodity owner would own the commodity through the process and would notionally acquire natural gas at the LNG facility inlet meter. However, only the facility owner may have a permanent establishment in BC and have material taxable income allocated to BC. Thus, absent further planning, there may be no benefit from the Gas Credit within the structure.

Partnership structures can be useful in addressing mismatches such as the one described above. For example, instead of the activities being carried out by the commodity owner and facility owner in corporate form, the activities could be undertaken in partnerships (the “commodity partnership” and the “facility partnership”). By virtue of their interest in the partnerships, the members of the partnerships would, very generally, be allocated the income, attributes and credits from the partnerships’ activities; would have a permanent establishment in BC through their interest in the facility partnership; and would acquire or notionally acquire natural gas in proportion to their interest in the commodity partnership (see under the heading “Computation of the Credit” below for a discussion of the application of the Gas Credit in the context of a partnership structure). Thus, the Gas Credit could be applied against the members’ income tax liability on taxable income allocated to BC.[79]

Entitlement to the Gas Credit becomes more difficult if a non-resident is the commodity owner. In this case, a benefit from the credit may be available only by structuring the transactions such that a Canadian upstream gas owner/producer becomes an LNG taxpayer. This may be accomplished by having the upstream owner/producer sell the feedstock gas to the non-resident commodity owner after the LNG facility inlet meter, resulting in the upstream owner/producer being deemed to acquire natural gas at the LNG facility inlet meter. Properly structured (i.e. through the use of one or more partnerships), the Gas Credit may then be able to be used to offset the BC tax liability arising on taxable income from the natural gas processing activities undertaken in BC.

Computation of the Credit

The Gas Credit is computed as 0.5% of the corporation’s “eligible cost of natural gas” for a taxation year,[80] being the total cost as determined under the LNG Act of all natural gas acquired or notionally acquired in the taxation year by the qualifying corporation (or a partnership of which the corporation is a member) at the LNG facility inter meters for an LNG facility. The notional acquisition of natural gas at an LNG facility is discussed in Part A above.[81]

The amount of the Gas Credit that can be used in any particular year to reduce BC income taxes payable is the least of (i) the credit as computed above; (ii) the amount that would reduce the corporation’s BC provincial income tax rate to 8% from 11%; and (iii) the corporation’s BC provincial income tax otherwise payable.[82] Any unused credit may be carried forward indefinitely, provided the corporation maintains a permanent establishment in BC in each taxation year.[83]

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The Gas Credit can be applied against BC provincial income tax on all of the taxpayer's income (not just LNG income) allocated to BC, subject to the limitation above. However, the credit cannot be applied to reduce LNG Tax payable.

Application to Partnerships

The Gas Credit rules accommodate activities carried on through a partnership. If a qualifying corporation is a member of a partnership, the corporation's eligible cost of natural gas for purposes of the Gas Credit is an amount equal to the qualifying corporation's appropriate portion of the partnership's eligible cost of natural gas.[84] The amount of the partnership's eligible cost of natural gas is determined, in turn, as if the partnership were a qualifying corporation.[85] As a "deemed" qualifying corporation, the partnership's eligible cost of natural gas is the cost, as determined under the LNG Act, of all natural gas acquired or notionally acquired by the partnership at the LNG facility inlet meters for an LNG facility.

Although not entirely clear, it appears that the Gas Credit rules also accommodate multi-tier partnership structures. This interpretation requires that a first tier partnership be a "deemed" qualifying corporation for purposes of determining whether the first tier partnership is a member of the second tier partnership.[86] The application of the Gas Credit in the context of multi-tier partnerships would be consistent with the treatment of multi-tier partnerships under the LNG Act.[87]

PART C – GGIR, PROVINCIAL SALES TAX AND CARBON TAX

Cap and Trade Proposal

BC has committed to having the world's cleanest LNG facilities. The centrepiece of BC's commitment is the GGIR, which addresses the management of greenhouse gas emissions, including combustion, electricity generation, venting and fugitives, from the point where gas enters a facility to where it is loaded on to ship or rail for market. The details of the greenhouse gas regime for the LNG industry have not been finalized as of the time of writing, but are expected to be included in the GGIR Regulations forthcoming in 2015.[88]

The GGIR sets a bench mark of 0.16 carbon dioxide equivalent tonnes ("tCO2e") per tonne of LNG produced.

LNG facilities with emissions exceeding the 0.16 tCO2e limit can comply with the GGIR by earning or purchasing compliance units. Units can be earned as follows:

- Funded units, which can be earned by payment of $25 per tCO2e to the BC government. The proceeds from funded units will be invested in technology to reduce greenhouse gas emissions;

- Offset units, which can be earned from reducing greenhouse gas emissions by using an approved offset, which must be confirmed by an independent verification procedure;

- Earned credits, which are emissions credits from a previous period carried over to a current period; and

- Recognized units, which can be transferred from other recognized jurisdictions. It is expected that the emissions credits generated in Alberta will be recognized units in BC.

LNG facilities that are below the 0.16 tCO2e benchmark will receive a credit that can be sold or banked and used later as an earned credit. If a facility exceeds the benchmark and has not purchased additional units, penalties can be imposed. Penalties can be appealed to the Environmental Appeal Board. The GGIR also allows citizens to request the Conservation Officer Service to investigate possible offences.

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Carbon Tax

Overview of the Carbon Tax

BC introduced a carbon tax in 2008 that applies to the use of fossil fuels in BC. The rate of carbon tax is $30 per tCO2e emitted. The purpose of the carbon tax is to encourage a market response to reduce emissions. The carbon tax is a "revenue-neutral" tax, and all proceeds go back to the public through various tax incentives or refund programs.

The carbon tax is based on the carbon intensity of each fossil fuel, and since natural gas has a lower carbon intensity than other fuels such as coal or gasoline, natural gas is subject to lower rate of carbon tax. Carbon tax, similar to BC's fuel tax, is levied on a volume of fuel as opposed to the purchase price of fuel, and the tax cost is therefore independent of any fluctuations in fuel prices. The current rate of carbon tax is related to a carbon price of $30/tCO2e and any increase to the carbon price would also increase the carbon tax rate on natural gas and other fuels. The carbon tax on natural gas has been set at $0.057 per cubic metre (m3) or $1.4898 per GigaJoule (GJ) since July 1, 2012.[89]

In limited circumstances, there is no carbon tax on fuel exported outside of BC[90] and fuel that is used as a raw material in an industrial process to produce or upgrade another fuel, or to manufacture another substance.[91] Carbon tax also does not apply on natural gas that is not combusted and is used as a refrigerant in a closed system in the processing of natural gas.[92]

In the case of an LNG facility, only the natural gas that is consumed in the operation of the facility (e.g., to power compressors and other activities relating to the operation of the facility) will be subject to the carbon tax. Feedstock gas purchased for liquefaction will not attract carbon tax.

During its 2013 budget process, the BC government reviewed all aspects of the carbon tax, including the impact of the carbon tax on BC businesses. Economic analysis indicated that the tax had a small negative economic impact in BC. The BC government decided that it would not raise the carbon tax rate or expand the tax base currently, but would revisit the decision after 2016 in light of the potential for other jurisdictions, especially those in North America, to introduce a similar tax or levy.[93]

Impact of Carbon Tax on LNG Industry in BC

The carbon tax is expected to increase the operating costs of LNG facilities in BC relative to other international jurisdictions that do not have a carbon tax. While carbon tax does not apply on natural gas that is converted to LNG for export, carbon tax does apply on the natural gas consumed within the facility. The tax on the consumed natural gas can be significant, especially if natural gas is used exclusively as the power source for the generation of electricity for the plant equipment and compressor turbines.

LNG proponents may have a number of options to reduce natural gas consumption and therefore the payment of carbon tax. One option is for a facility to use hydroelectric power where possible. When considering the carbon tax savings, electricity may be a low cost alternative for non-compressor needs, which could help counteract increased natural gas costs. The use of hydroelectricity will also support BC's objectives for clean LNG development with a low carbon intensity.

It should be noted that GGIR provides a consequential amendment to the Carbon Tax Act that allows the Lieutenant-Governor in Council to provide an exemption or refund of carbon tax by regulations with respect to a fuel or combustible that is a source for greenhouse gas emissions of a regulated operation under the GGIR that has a compliance obligation under GGIR. When the GGIR Regulations are released, one should also review the regulations under the Carbon Tax Act to determine the refunds or exemptions available.

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BC Provincial Sales Tax

Overview of BC PST

BC introduced the *Provincial Sales Tax Act* (the "**PSTA**") in the spring of 2013. Pursuant to the PSTA, BC imposes PST at the rate of 7% on all in-province purchases and leases of tangible personal property or software in BC and imports of tangible property or software into BC (including the value of labour inherent in the imported property), unless a specific exemption applies.[94] PST also applies to certain services acquired in BC, including legal services and services to tangible personal property. PST does not apply to purchases of real property (for example, land or affixed buildings), intangibles (such as oil and gas rights), or fuels that are used in a combustion engine. PST also does not apply to property purchased for resale or raw materials used to manufacture or produce a new product for resale.

Unlike federal Goods & Services Tax/Harmonized Sales Tax and other value-added taxes, PST is not a recoverable tax and thus is a real cost to LNG proponents. The PST associated with the construction of the LNG facility, dedicated pipelines, and other infrastructure is enormous and represents a major hurdle for an economically viable project.

Production Machinery and Equipment Exemption

The PSTA and related regulations contain a PST exemption for the purchase or import of qualifying production machinery and equipment ("**PME**"), including parts and materials, used directly and primarily (over 50%) in the manufacturing of tangible personal property[95] or processing of natural gas.[96] The qualifying PME must be located on a manufacturing site or a processing plant. The exemption is available to a number of entities, including the following:

- A manufacturer (including a person that manufactures tangible personal property with a reasonable expectation of sales of over $30,000 a year, or for the person's own business use with a reasonable expectation that the total manufacturing cost will be over $30,000);
- An oil and gas producer (including a person who extracts or processes natural gas for sale with a reasonable expectation of total sales of over $30,000 or extracts or processes natural gas for own use with a reasonable expectation of total manufactured cost of over $30,000); and
- A service provider that meets a number of conditions.

An entity that only provides manufacturing or processing services to third parties will not meet the definition of a manufacturer or an oil and gas producer but may qualify as a service provider.[97] A service provider will be eligible to claim the PME exemption if the following conditions are met:

- The service is provided to, or results in the creation of, tangible personal property that will be, or will become part of, the tangible personal property of the manufacturer or the natural gas of the oil and gas producer;
- The machinery and equipment is used primarily (over 50%) and directly in providing the service;
- The service is performed at either the service provider's or the manufacturer's qualifying manufacturing site or processing plant; and
- There is a reasonable expectation that the total value of sales of the services will exceed $30,000 per year.

BC administrators have taken the position that the PME exemption is not applicable to the purchase or importation of machinery and equipment that will be located at an LNG facility and used to convert natural gas to LNG. Specifically, BC has provided the following information on its website:[98]

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> Do liquefied natural gas (LNG) producers qualify as manufacturers eligible to obtain production machinery and equipment (PM&E) exempt from PST?
>
> No. The PM&E exemption for manufacturing does not apply to LNG production. However, while liquefied natural gas processing does not qualify as manufacturing, there is a PM&E exemption for qualifying oil and gas producers. LNG producers may be eligible for the PST exemption for PM&E obtained for use in the extraction or processing of natural gas.
>
> To qualify for this exemption, the machinery and equipment must be obtained by a qualifying oil and gas producer for use primarily and directly in the processing of natural gas at the qualifying part of a processing plant. The qualifying part of a processing plant ends at the point at which the natural gas being processed has become a marketable product. Natural gas becomes a marketable product when it is pipeline quality, meaning it meets the content specifications required by pipeline operators to enter transmission pipelines (e.g. high pressure intra and inter-provincial transmission pipelines transporting natural gas to distribution centres). Once the natural gas is a marketable product, any machinery and equipment used to process or further process that natural gas, including the equipment used to convert the gas into LNG, does not qualify for exemption. [emphasis added]

Thus, the BC administrators' view is that natural gas is already a marketable product at the time it reaches the LNG facility and that the PME exemption does not therefore apply to the purchase or import of PME for an LNG facility.

Innovative Clean Energy Fund

The PSTA imposes an additional tax of 0.4% of the purchase price on energy products, including natural gas, fuel oil used for the purpose of heating, cooling and raising steam (other than kerosene), and propane gas delivered by a public utility and pipe to support BC's Innovative Clean Energy Fund (the "**ICE Levy**") to a maximum of $100,000 per year per person.[99] This additional charge will apply to both in-province purchases and imports of energy products. There is an exemption for fuel subject to the Motor Fuel Tax and natural gas that is used in a stationary combustion engine that compresses natural gas. An LNG facility would likely be required to pay the ICE Levy if it purchases natural gas, fuel oil or propane delivered by public utility and pipe during the set-up or operation phase of the facility for its own use. The ICE levy does not apply to the feedstock natural gas.

Exemption for First Nation Bands or Individuals

Certain PST exemptions are available for First Nation bands and individuals involved with LNG project development. Purchases made by First Nation bands or individuals on First Nation land are PST exempt.[100] Thus, general partnerships will be able to purchase goods and services exempt from PST in situations where the partnership has a First Nation partner who is eligible to make exempt purchases, and the purchase is made on First Nation land.[101] The PST exemption will be proportional to that First Nation partner's interest in the partnership, if the purchase meets all the criteria for the exemption. The exemption does not apply where a partner is a First Nation corporation. Project structures that involve a First Nation band should be carefully considered so that any available exemptions are obtained.

Exemption for Vessels Over 500 Tons

The PSTA's regulations provide a PST exemption for the purchase or lease of a "self-propelled vessel of more than 500 tons gross".[102] This exemption may be beneficial in respect of a floating LNG facility or floating LNG storage. If the vessel that is purchased or leased for these purposes meets the definition of a "self-propelled vessel of more than 500 tons gross" in its ordinary meaning at the time of purchase or import of the vessel, the portion of the purchase price or lease payment attributable to the vessel may be PST exempt.

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CONCLUSION

The enactment of the LNG Act, the Gas Credit and the GGIR allows proponents to incorporate, with greater certainty, tax implications into determining the overall economic viability of their BC LNG projects, and to take steps necessary to ensure that their proposed commercial structures are as tax efficient as possible. However, market conditions continue to evolve rapidly, and tax is only one of the factors that will determine the competitiveness of a Canadian LNG project. Global supply/demand considerations, costs (both capital and ongoing operating), regulatory approval conditions, First Nations support, and the state of the global debt and equity capital markets, among other factors, will be critical for a viable project. All stakeholders must work together to make a Canadian LNG export industry a reality.

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1 Bill 6 and Bill 2 come into force by regulation of the Lieutenant Governor in Council.
2 R.S.C. 1985, c. 1 (5th Supplement), as amended.
3 R.S.B.C. 1996, c. 215.
4 Definition of "LNG source" in section 1 and the definition of "LNG facility" in section 7.
5 Sections 18 and 21.
6 Definition of "taxpayer" in section 1.
7 A "person" is defined in section 1 to have the same meaning as in subsection 248(1) of the federal ITA. A person is defined in subsection 248(1) of the federal ITA to include "any corporation, and any entity exempt, because of subsection 149(1), from tax under Part I on all or part of the entity's taxable income and the heirs, executors, liquidators of a succession, administrators of other legal representatives of such a person, according to the law of that part of Canada to which the context extends".
8 Section 22.
9 It is well established that a partnership is not a person for purposes of the federal ITA, except where the partnership is deemed to be a person for specific provisions of the federal ITA (see for example *Devon Canada Corporation v. The Queen*, 2014 DTC 1043 at paras. 42-43; and CRA Interpretation Bulletin IT-90, "What is a Partnership?"). Thus, a partnership is also not a taxpayer for purposes of the LNG Act.
10 Section 21.
11 Section 18.
12 Definition of "liquefaction activities" in section 1. The definition of "liquefaction activities" specifically excludes "prescribed activities". It is uncertain whether the LNG Regulations will prescribe activities that are excluded from liquefaction activities, even though they may fit within the definition of liquefaction activities in the LNG Act itself.
13 In this regard, it is not clear at what point an LNG facility "begins". Refer to the discussion of the deemed cost of natural gas under the heading "Transfer Pricing Considerations" below.
14 An analysis of whether the application of LNG Tax to non-residents may be outside the constitutional powers of the province of BC is beyond the scope of this article. We have also not addressed herein the province's enforcement powers over non-residents in relation to LNG Tax, although enforcement powers may be addressed in the LNG Regulations when released.
15 Since BC is not a party to Canada's tax treaties, BC is not bound by the terms of such treaties unless specifically incorporated into provincial legislation.
16 Paragraphs 54(2)(b) and 54(3)(b).
17 Subparagraphs 23(c)(ii) and 24(a)(ii); and section 46.
18 Subsection 60(1).
19 Subsections 60(3) and (4).
20 Section 61.
21 Definition of "capital investment property" in section 1, with reference to the definitions of "LNG facility" and "LNG plant" in sections 7 and 8.
22 Subsection 64(1).
23 Section 4.
24 Section 85.
25 Paragraph 46(2)(a).
26 Sections 23 through 25.
27 There are many provisions in the LNG Act that address the applicability of provisions in the federal ITA for purposes of the LNG Act. Section 2 of the LNG Act states that the definitions in the federal ITA and the federal Regulations apply for purposes of the LNG Act unless a contrary intention appears in the LNG Act or the LNG Regulations. Section 4 of the LNG Act states that in any case of doubt, the provisions of the LNG Act must be applied and interpreted in a manner consistent with similar provisions of the federal ITA. Subsection 126(1) of the LNG Act provides that the federal Regulations apply for the purposes of the LNG Act except to the extent that a provision of the federal Regulations is inconsistent with the LNG Act or LNG Regulations or is made expressly inapplicable. A complete analysis of the relevance of provisions of the federal ITA and Regulations to the LNG Act is beyond the scope of this article.
28 Subsection 30(1).
29 Subsection 37(1), subsection 34(2), and the definition of "financing charge" in section 1.
30 Paragraphs 32(b) and 34(1)(c).
31 Paragraphs 32(a) and paragraph 34(1)(b).
32 Subsection 37(1).
33 Subsection 26(3).
34 The investment allowance must be prorated for short taxation years: subsection 46(5).
35 Definition of "qualifying expenditure" in section 83.

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36 Paragraph 54(2)(b) and section 55.
37 Paragraph 54(3)(a) and section 56.
38 Paragraph 54(3)(b) and section 57.
39 Part 8 of the LNG Act.
40 By operation of paragraph 122(1)(b) and the deeming rules in section 123.
41 Section 124 and the definition of "last taxation year" in subsection 121(1).
42 Sections 98 and 99.
43 Subsection 26(2), paragraph 31(d), and section 107. Paragraphs 44(c) and 45(b) also provide that the taxpayer must include or may deduct an amount that under Part 6 is income or a deduction of the taxpayer for the taxation year from another source described in Division 3 or Division 4, as applicable.
44 Sections 42 and 43.
45 Section 103.
46 Section 111.
47 Subsection 113(1).
48 Subsection 113(2).
49 Section 110.
50 Section 46.
51 Subsection 114(1). A taxpayer that disposes of an interest in a partnership at a particular time is deemed to have disposed of capital investment property at that time in an amount equal to the taxpayer's share of the fair market value of the partnership's capital investment property at that time.
52 Section 97.
53 Subsection 77(2).
54 Paragraph 79(5)(a).
55 Paragraph 79(5)(b).
56 Section 80.
57 Section 81.
58 Paragraph (a) of the definition of "notionally acquired" in section 47; section 48; section 49; and section 50.
59 Paragraph (b) of the definition of "notional acquired" in section 47; section 48; and section 50.
60 Section 50.
61 Paragraph 50(2)(a) and section 51.
62 Paragraph 50(2)(b) and section 52. The adjustment recognizes that, notwithstanding that the taxpayer may own the gas as it passes through the LNG facility inlet meter, the cost of the gas should be based on the amount actually paid or payable for the gas if acquired from an arm's length person.
63 Paragraph 52(2)(c) and section 53.
64 Definition of "LNG facility inlet meter" in section 1.
65 Definition of "feedstock spur pipeline" in section 1, in part by reference to the definition of "LNG plant" in section 8.
66 Definition of "LNG facility" in section 7 and subparagraph 8(1)(a)(i) of the definition of "LNG plant" in section 8.
67 Subsection 28(5).
68 Definitions of "LNG facility", "LNG plant" and "land" in sections 7, 8 and 1, respectively.
69 As described in subsection 87(1).
70 Sections 94 and 95.
71 Section 93.
72 Section 91.
73 Subsection 87(2).
74 Section 55.
75 Paragraph 60(1)(a).
76 Sections 104 and 105 in the context of a partnership; and sections 119 and 120 in the context of a trust.
77 Definition of "qualifying corporation" in subsection 172(1) of the BC ITA.
78 Generally, for income tax purposes, taxable income is allocated to provinces in which there is a permanent establishment on the basis of revenues and wages/salaries in each province.
79 The provincial allocation of income would need to be modelled to ensure adverse consequences do not arise based on, for example, the revenues and employees located in each province.
80 Subsection 172(4) of the BC ITA.
81 Subsection 172(5) of the BC ITA.
82 Subsection 172(2) of the BC ITA.
83 Subsections 172(3) and 172(7) of the BC ITA.
84 Paragraph 172(5)(b) of the BC ITA.
85 Paragraph 172(6)(a) of the BC ITA.
86 This essentially requires a circular reading of paragraphs 172(5)(b) and 172(6)(a) of the BC ITA.
87 Refer to the discussion of multi-tier partnerships under the heading "Partnerships under the LNG Act" in Part A above.
88 With the introduction of the GGIR, the *Greenhouse Gas Reduction (Cap and Trade) Act* is intended to be repealed in its entirety.
89 *Carbon Tax Act, Schedule 1*, also see Bulletin MFT-CT 005, *Tax Rates on Fuel*
90 Paragraph 14(2)(c) of the *Carbon Tax Act.*
91 Section 16 of the *Carbon Tax Regulation*.
92 Section 17 of the *Carbon Tax Regulation*.
93 http://www.fin.gov.bc.ca/tbs/tp/climate/Carbon_Tax_Review_Topic_Box.pdf
94 PST is imposed on the purchaser, and thus a purchaser is liable for self-assessing the PST if the supplier fails to charge PST on the taxable property or service.
95 PSTA's *Provincial Sales Tax Exemption and Refund Regulation*, section 92.
96 PSTA's *Provincial Sales Tax Exemption and Refund Regulation*, section 95.
97 PSTA's *Provincial Sales Tax Exemption and Refund Regulation*, section 103.
98 http://www2.gov.bc.ca/gov/topic.page?id=CE70BF6CB8424CA9A38F1F6C33EE7E1D#LNG-PM&E

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99 Sections 92 and 93 of the PSTA.
100 *Indian Act* (Canada), section 87. Also see PST Bulletin 314, "Exemption for First Nations", October 2013.
101 PST Bulletin 319, "Partnerships", December 2013.
102 PSTA's *Provincial Sales Tax Exemption and Refund Regulation*, paragraph 55(1)(d).

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