GUIDELINES FOR TAX TREATMENT ON LEASE EXPENSES FOR SPECIAL ASSETS UNDER THE PETROLEUM (INCOME TAX) ACT 1967 (PITA)

1. INTRODUCTION

1.1 The petroleum industry in Malaysia is a contributor to the country's revenue.

1.2 The Petroleum Development Act 1974 (PDA) was gazetted and Petroliam Nasional Berhad (PETRONAS) was granted the entire ownership in and the exclusive rights, powers, liberties and privileges of exploring, exploiting, winning and obtaining petroleum whether onshore or offshore of Malaysia.

1.3 The role of PETRONAS includes regulating and managing the development of the country's petroleum operations. This includes the awarding of petroleum agreements such as Production Sharing Contracts (PSC) to international and domestic oil and gas companies for the purpose of exploring, exploiting, winning and obtaining petroleum whether onshore or offshore of Malaysia.

1.4 The Field Development Plan (FDP) for each petroleum agreement must be approved by PETRONAS. Therefore, Chargeable Person through their respective petroleum agreements would have to obtain the approval from PETRONAS as to whether the special assets such as Floating Production System (FPS), Floating Production Storage & Offloading (FPSO) and

Floating Storage & Offloading (FSO) that is being used in oil and gas production are to be built or leased.

1.5 FPS is a general term for all variants of floating production system.

1.6 FPSO is a floating structure that is used by the offshore oil and gas industry for the production and processing, offloading and storage of hydrocarbons. FPSO is designed to receive hydrocarbons produced by itself or from nearby platforms, process and store until it can be offloaded to tankers or transported through pipelines. FPSO is usually modified from oil tankers or a specially built structure for the purpose of producing and processing hydrocarbon in petroleum operations.

1.7 If a floating structure is used only to store and offload hydrocarbon (without processing), it is known as FSO.

2. OBJECTIVE

This guideline is issued to provide clarity on the tax treatment of lease expenses for special assets such as FPS, FPSO and FSO under the provision of subsection 15(1) of PITA.

3. LEASE

3.1 In general, a lease is an agreement where a party i.e. the owner of an asset (the lessor) provides an asset for the use of the lessee with a fixed or flexible consideration (rent) and for a certain period whether fixed or flexible (lease period).

3.2 The lease applicable under this guideline is the lease that allows for the use of an asset with the ownership rights of the asset remains with the lessor at the end of the lease period.

4. SPECIAL ASSETS LEASE

4.1 In the petroleum upstream industry, special assets such as FPS, FPSO and FSO are high technology assets and widely used in the oil and gas production.

4.2 The parties involved in entering into a special asset lease agreement are:

a) The lease provider (lessor) is the party providing special asset lease services and is the beneficial / legal owner of the leased asset or property; and

b) The lease recipient (lessee) is the Chargeable Person who uses such special assets to carry out petroleum operations.

4.3 Even though the following terms in the lease agreement indicated the existence of a deemed sale arrangement under accounting standards,

a) Asset Ownership
The lessor is the legal or beneficial owner of the leased assets. In the lease agreement, the lessor refers to the "owner" or "contractor" while the lessee refers to "company" or "charterer" or the like meaning;

b) Lease Period
The lease term of a lease agreement is dependent on the hydrocarbon production period;

c) Option to Purchase
The lessee is given the option to purchase the asset within the lease period or at the end of the lease agreement period;

d) Insurance

The lessor is responsible for managing, taking and incurring the cost of insurance for the duration of the lease;

e) Equipment inspection & testing

All costs and expenses related to inspection and testing of equipment are borne by the lessor throughout the lease period. However, there are times when this activity is under the responsibility of the lessee;

f) Maintenance

The maintenance of the lease assets is under the responsibility of the lessor during the lease period. However, there are times when maintenance is under the responsibility of the lessee;

g) Operating licenses and permits

The lessor is solely responsible for obtaining the approval of the asset's license and operating permit according to the specifications set by the Government of a country, especially Malaysia. The process and cost involved in obtaining licenses and permits are borne by the lessor;

it is however different in determining the tax treatment of lease transactions on special assets under PITA. This is because the ownership of special assets at the end of the lease period (in substance) is still with the lessor. Therefore, the lease expense for this special asset qualifies for deduction under subsection 15(1) of PITA.

5. TAX TREATMENT OF SPECIAL ASSET LEASES

5.1 Based on the general principle, lease expenses are essentially recurring rental payments, revenue in nature and part of the expenditure in generating income.

5.2 Lease expenses incurred by the lessee are allowed under subsection 15(1) of PITA provided that the expenditure is wholly and exclusively incurred in the basis period in the production of gross income.

5.3 If the expenditure incurred is a qualifying capital expenditure under the Second Schedule, PITA, hence a claim for capital allowance is allowed.

Example :

POSB/PMSB entered into a petroleum agreement with PETRONAS to conduct petroleum operations for the SK-A PSC area. The FDP was approved by PETRONAS on 2 May 2020 which includes production of petroleum through a special aset, namely FPSO, leased from ABC Limited.

POSB as the operator of SK-A PSC has entered into an FPSO lease agreement with ABC Limited from the period of first production on 1 January 2023 and the expiry of the PSC is 31 December 2043 (20 years). The agreed price for the monthly lease payment is USD1 million for 20 years.

Apart from the leasing, POSB has also bought additional assets from ABC Limited such as Subsea Equipment comprising of Electrical Power Unit (EPU), Master Control Station (MCS) and Hydraulic Power Unit (HPU) at the price of USD150 million to complement the function of the FPSO.

Details	**Total (USD)**	**Ownership**
Purchase price of additional assets	150 million	Chargeable Person
Lease expenses	1 million a month for 20 years	Lessor

Tax treatment on the FPSO lease expenses and the cost of additional assets are as follows:

a) The Chargeable Person qualifies to claim the lease expenses incurred for the FPSO amounting to USD1 million on a monthly basis under subsection 15(1) of PITA if it complies with the provisions under the said subsection.

b) The purchase of the additional assets totalling to USD150 million are capital expenditure that would potentially qualify for capital allowance pursuant to Second Schedule, PITA, if it complies with the provisions under the said Schedule.

6. DISCLAIMER

Example in this guideline is for illustrative purposes only and are not exhaustive.

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