Tax and legal services

AB Klaipėdos nafta
Accounting and tax implications of transfer of the LNG terminal operator's activities

Memorandum

Confidential

31 December 2018

Important notice to persons who do not have a contract with UAB PricewaterhouseCoopers and have not signed a letter on use of this report

This memorandum has been prepared by UAB PricewaterhouseCoopers, following instructions given by AB Klaipėdos nafta, in order to assess tax and accounting implications, which may arise due to spin-off of the LNG terminal activities from AB Klaipėdos nafta and contributing the LNG terminal business into a newly established subsidiary.

By presenting this memorandum we do not assume any liability to any person other than AB Klaipėdos nafta, we present it only for the benefit of AB Klaipėdos nafta and only for the purpose indicated herein, irrespective whom this memorandum may come to, unless we agree in writing otherwise.

If this memorandum comes into the hands of any other person, by reading this memorandum such a person confirms and consents to the following :

- Such a person understands that the work performed by UAB PricewaterhouseCoopers was performed following instructions given by AB Klaipėdos nafta, exclusively for the benefit of and for use of AB Klaipėdos nafta.
- Such a person understands that this report has been prepared exclusively following the Client's instructions and cannot cover all the procedures, which the reader may consider necessary.
- Such a person acknowledges that UAB PricewaterhouseCoopers, its partners, employees or representatives do not assume any contractual or non-contractual liability (including due to negligence or breach of duty) for any loss or damage suffered by such persons, who may read this memorandum, by reason of use of the memorandum.
- This memorandum cannot be quoted or published, in full or in part, in any prospectus, public information or notice, contract or any other document and cannot be provided to third parties without a prior written consent of UAB PricewaterhouseCoopers.

AB Klaipėdos nafta
Burių g. 19
LT-92276 Klaipėda

This memorandum is presented presuming that it will be used only by AB Klaipėdos nafta and parties associated with it, which directly take part in the planned LNG terminal spin-off process. This memorandum can also be provided to other consultants of the Company, which assist the Company in the process, but only in connection with the LNG terminal restructuring project. PwC does not assume any liability to any other person who will get access to this memorandum.

Rasa Radzevičienė
Partner
Tel.: +370 686 16616
rasa.radzeviciene@pwc.com

Nerijus Nedzinskas
Partner
Tel.: +370 610 98488
nerijus.nedzinskas@pwc.lt

Egidijus Kundelis
Senior Project Manager
Tel.: +370 686 55018
egidijus.kundelis@pwc.com

Jonas Balsys
Senior Project Manager
Tel.: +370 682 71407
balsys.jonas@pwc.com

Dear Sirs and Madams,

Following the agreement made on 19 September 2018 between AB Klaipėdos nafta (the **Company**) and UAB PricewaterhouseCoopers (**PwC**) on accounting and tax consultancy services, we have performed an analysis of accounting and tax implications of spin-off of a part of the Company's business and present this memorandum.

The memorandum gives an overview of the current and planned structure of the Company, the accounting and tax assessment of the chosen business spin-off method and other alternatives.

If you have any questions or wish to discuss the findings and proposals offered in this report, please do not hesitate to contact us at any time of your convenience.

After you read this memorandum, we are ready to present the results of our analysis during a meeting.

UAB PricewaterhouseCoopers

UAB PricewaterhouseCoopers
J. Jasinskio g. 16B, LT-03163 Vilnius
Tel.: +370 523 92300
Fax: +370 523 92301

Rasa Radzevičienė	Nerijus Nedzinskas	Egidijus Kundelis	Jonas Balsys
Partner	Partner	Senior Project Manager	Senior Project Manager

Table of contents

Scope and progress

Scope	Progress
Agreement on accounting and tax consultancy services	On 19 September 2018, the Company and PwC entered into the agreement on accounting and tax consultancy services (the Agreement), under which PwC undertook to perform an accounting and tax assessment of the scenario of spin-off of the liquefied natural gas (LNG) terminal operator's activities (the LNG business) selected by the Company and of its two alternatives.
Work scope and principles	Referring to the information presented by the management of the Company, PwC performed an analysis of accounting and tax issues of spin-off of the Company' s LNG terminal operator's business but did not assess any other possible legal or business risks.
Memorandum	In this memorandum, we present the accounting and tax analysis of the received information, assessments and recommendations. The memorandum is based on documents and information that the Company provided on the conditions stipulated in the Agreement, as well as laws and other regulatory legal acts of the Republic of Lithuania, as effective, adopted and published at the time of provision of the services, officially published draft legal acts of the Republic of Lithuania, international treaties and agreements, to which the Republic of Lithuania is a party, as well as directives and regulations of the European Union applicable in the Republic of Lithuania. Performing the accounting and tax analysis, we presumed that all the information and documents presented by the Company are true and correct and properly reflect the essence of the conducted transactions, that original documents were made and signed by duly authorised representative of their respective parties and that all document copies correspond to the originals, unless the Company indicates otherwise. PwC is not liable for changes in regulatory legal acts occurring after the date of completion of all the services and for different practices of application of regulatory legal acts, in spite of the fact that these changes and practices can have an effect on the presented conclusions and recommendations. As for matters, which are not accurately and/or expressly regulated in regulatory legal acts, we could only state our opinion on them, however, we cannot guarantee that it will necessarily coincide with subsequent interpretations by courts or other state or municipal authorities.

Summary

- We have performed an assessment of accounting and tax implications of the proposed spin-off of the LNG terminal business from AB Klaipėdos nafta. This spin-off will be performed by contributing the LNG terminal business to the newly established subsidiary (SPV). Our main observations and comments, upon implementation of the planned transaction structure according to the legal analysis performed by TGS, are presented below.

Key accounting comments

- According to the preliminary spin-off balance sheet as of 30 September 2018 prepared by the management, the book value of liabilities of the LNG business exceeds the book value of the assets of LNG (without accurate evaluation of the impact of the new accounting standard IFRS 16 *Leases*, which will come into effect on 1 January 2019). Transferring assets and liabilities at their book values, KN will have to contribute an additional capital amount in cash in order that the total capital book value of the SPV according to the IFRS as on the spin-off day would be positive and would conform to the requirements of the Law of the Republic of Lithuania on Companies.
- The value of the SPV share capital will be set using the fair value of the business determined by independent valuators. The difference formed in separate financial statements of the SPV between the fair value of the business and the book value of contributed net assets (including the cash amount contributed in addition) will be recorded as a negative reserve. This negative reserve will reduce the SPV 's possibility to pay dividend after the spin-off.
- Assets and liabilities of the LNG terminal will be recorded at book value both in separate financial statements of the SPV and in the consolidated financial statements of KN. A potential increase (if any) in the value of assets, as determined by independent valuators, would not be recorded in asset items as this spin-off is not considered a business combination and in such a case the IFRS do not provide for a possibility to recognise an increase in asset value.
- Most assets and liabilities were assigned to the LNG terminal business according to the direct identification method and conform to the methodology applied in note 5 "Information about segments" to the financial statements of KN. In some items, e.g. intangible assets, taxes on operations, deferred income tax, etc., the Company applied certain adjustments and appropriation principles in order to correctly reflect the transferred assets and liabilities. Compared to the information on the LNG segment prepared by the management of the Company as on 30 September 2018, the net assets preliminarily assigned to the SPV (total assets minus total liabilities) was minus EUR 903,000.
- As the SPV business will be significant, after the spin-off, KN (AB Klaipėdos nafta continuing after the spin-off) will have to start preparing consolidated financial statements, which will have to be audited.

* Presenting these observations, we referred to significant assumptions (see page 10).

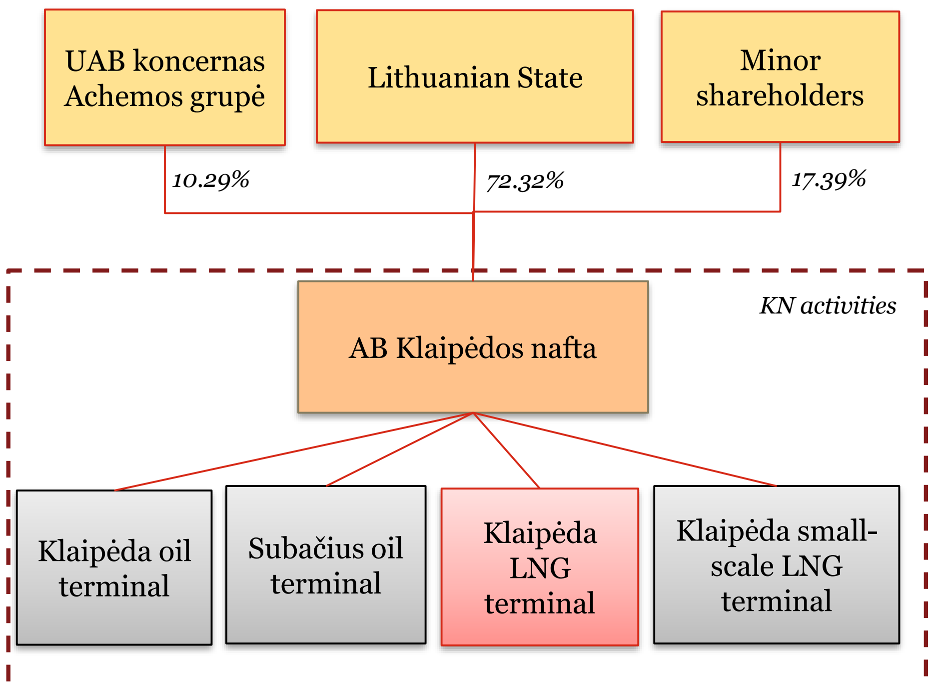
Summary (continued)

Key tax comments

- This transaction of spin-off of the LNG terminal business from KN contributing it to the SPV will not be subject to the corporate income tax (paragraph 2(6) of Article 41 of the CIT Law) provided that KN holds the SPV shares received in exchange for at least 3 years.
- Transfer of a part of business is not regarded as an object of the VAT (paragraph 1 of Article 9 of the VAT Law), i.e. no VAT would be charged.
- Assets and liabilities would be calculated for the SPV tax assessment purposes and recorded at historical tax values that existed on the date of business contribution by KN .
- Transfer of the SPV shares would be tax neutral starting only 3 years after the spin-off.
- Please note that in case the amount of loans from related persons or the amount of loans guaranteed by related persons exceeded the amount of the fixed capital of the company at the ratio of 4:1, interest on the excess can be treated as non-allowable deductions. With regard to the data in the balance sheet as of 30 November 2018 given to us, there is such a risk.
- With regard to the 30% limit rule for deducting interest from the taxable EBITDA coming into force on 1 January 2019 and with regard to data in the spin-off balance sheet as of 30 November 2018 given to us, there is no such risk.

Memorandum

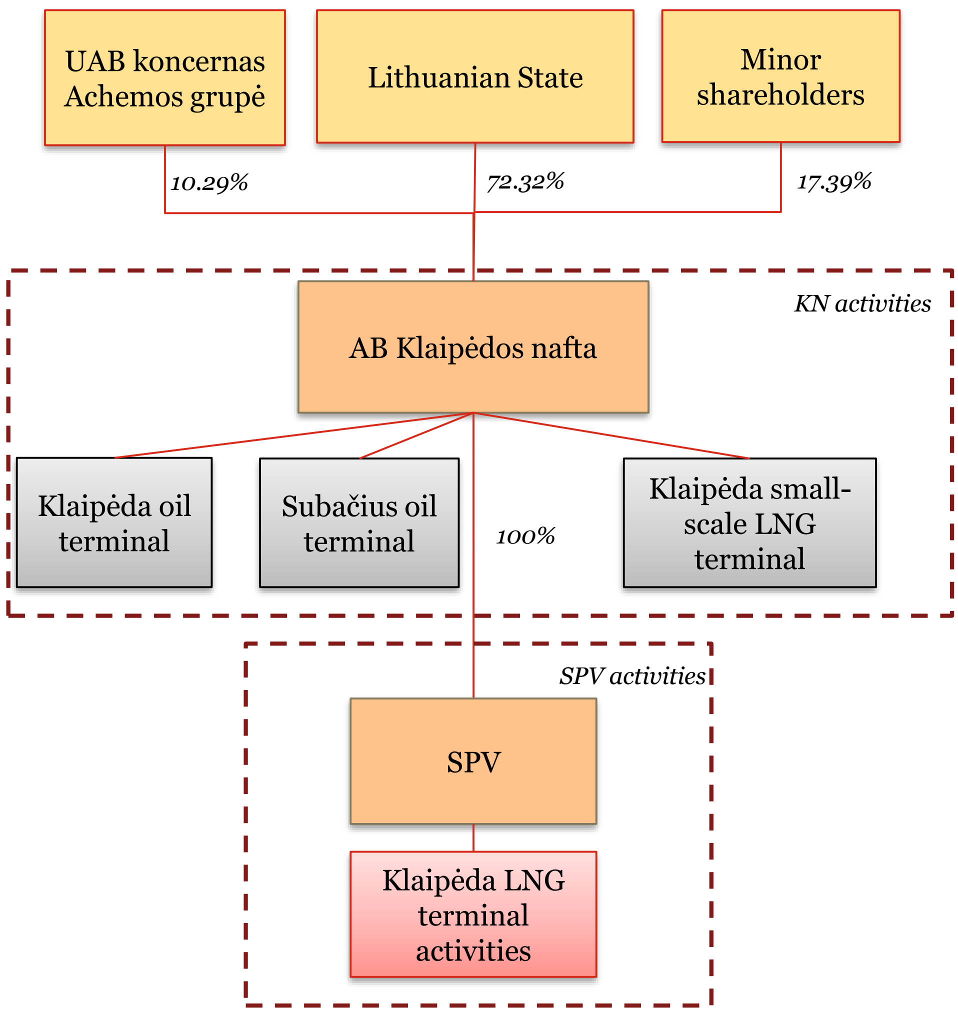
Current structure



Key information

- AB Klaipėdos nafta is a company operating in Lithuania, performing business of the operator of oil products terminals and liquefied natural gas terminals.
- Shareholders of the Company are:
  - Lithuanian State, represented by the Ministry of Energy of the Republic of Lithuania, holding 72.32% shares of the Company;
  - UAB koncernas Achemos grupė, holding 10.29% shares of the Company;
  - Minor shareholders, holding 17.39% shares of the Company.
- Activities of AB Klaipėdos nafta are divided into four segments:
  - Klaipėda oil terminal;
  - Subačius oil terminal;
  - Klaipėda LNG terminal;
  - Klaipėda small-scale LNG terminal.
- Business segments of the Company are both regulated and non-regulated by state authorities. Currently, the businesses of the Company are not separated into any separate companies.
- LNG terminal provides liquefied natural gas loading, liquefied natural gas storage, its regasification services and services of supply to the main pipelines.
- LNG terminal activities are regulated by the Law of the Republic of Lithuania on the LNG Terminal, the Law of the Republic of Lithuania on Natural Gas and other relevant legal acts issued by the National Commission for Energy Control and Prices.

Planned structure
Contribution of the LNG business as a business complex into the subsidiary (SPV)



- The Company seeks to spin-off the regulated business of the Klaipėda LNG terminal into a newly established and wholly controlled subsidiary (SPV) and in this way to separate risks inherent in this business from the rest of the Company's business.
- In the case at hand, the Company is going to establish a wholly controlled subsidiary (SPV) and to transfer the LNG terminal business to it in exchange of the SPV shares.
- The Company is going to transfer the assets and liabilities (including loans) related to the LNG terminal business being spun-off as a property complex to the newly established SPV as a non-monetary contribution towards increase of the SPV authorised capital.
- The Company is going to spin-off the LNG terminal business in accordance with paragraph 2(6) of Article 41 of the CIT Law, when an entity, continuing its activities (the transferring entity), transfers a business as a complex or one or more parts of the business to another entity (the acquiring entity) in exchange for the shares of the acquiring entity.

Purposes and assumptions

Purposes and scope of the analysis

- The purpose of the transaction is to separate regulated and non-regulated activities carried out by the Company and make them more efficient, separate risks of these different activities and related obligations. The Company seeks that transfer of the LNG business would happen transparently and fairly, ensuring both correctness of the regulated activities and interests of all the shareholders.
- The Company also seeks to transfer the business in the optimal manner, with regard to time costs and accounting/financial consequences, and to make sure that the transfer is tax neutral.
- Some activities of the Company are regulated, therefore, in performance of the business transfer scenario selected by the management of the Company, account must be taken of all regulatory requirements.

Our engagement

- Following the signed services agreement, PwC performed an assessment of accounting and tax implications of the spin-off of the LNG terminal operator's business as a property complex and its transfer to the SPV in exchange for its shares, as planned by the Company. We present the results of our analysis in this memorandum.
- In the memorandum, we have also analysed and assessed two LNG business transfer alternatives: sale of the LNG business as a property complex and transfer of the LNG business by separate transactions (in portions).
- Presenting our analysis, we followed:
  - the legal analysis of the LNG terminal business spin-off, prepared by law firm TGS (we did not separately assess the suitability of this analysis and of the steps indicated in it);
  - documents, accounting data and other information presented by representatives of the Company.

Assumptions

- The transaction will be structured as a contribution of a business into a newly established subsidiary wholly controlled by KN.
- An independent valuator will perform valuation of the whole contributed business. The book value of net assets of the contributed business will be positive. At the time of making this memorandum, no business valuation was presented to us, therefore, we could not review it.
- The Company will not need to prepare the carve-out financial information for comparative periods before the actual business spin-off. SPV financial statements will be made only for the period starting from the establishment of the SPV and the date of transfer of the LNG terminal business.
- The Company management is reasonably certain that the Company will acquire *Independence* vessel at the end of the lease from Hoegh LNG (in 2024) by use of the purchase option provided for in the agreement. The option terms have not been presented to us due to their confidentiality, therefore, we cannot present our opinion on the accounting of this option according to IFRS 16 *Leases*.
- All assets and obligations, directly related to the LNG terminal business, will be transferred to the SPV.
- The book value of assets (including cash) contributed to the SPV will be more than the value of the contributed liabilities.

Accounting implications of the chosen transaction structure

With regard to the assumptions set out in page 10, below please find description and evaluation of the accounting implications of the transaction structure chosen by the management of the Company for the consolidated financial statements of KN, separate financial statements of KN and separate financial statements of SPV.

Consolidated financial statements of KN

- Currently, KN does not draw up consolidated financial statements as its subsidiary UAB LNG logistika is insignificant for the company group (according to the explanation given in note 2 to the financial statements of KN for 2017). The investment into this subsidiary is recorded at historical cost, less impairment.
- As the SPV activities will be significant, after the spin-off, KN will have to start making consolidated financial statements. They will have to be audited.
- The LNG terminal assets and liabilities will be recorded at book value both in the separate financial statements of SPV and in the consolidated financial statements of KN, as it is a transaction between companies under common control, to which the acquisition method of accounting according to IFRS 3 *Business Combinations* does not apply.
- A potential increase (if any) in the value of assets, as determined by independent valuators, would not be recorded in asset items as this spin-off is not considered a business combination and in such a case the IFRS do not provide for a possibility to recognise an increase in asset value.

Separate financial statements of KN

- After the spin-off, the transferred LNG assets, liabilities, income and expenses will not be recorded in relevant items of the separate financial statements of KN.
- According to the KN accounting policies, the investment into the SPV (subsidiary) will at first be recorded based on a historical cost approach in the separate financial statements of KN. The historical cost will be equal to the book value of the contributed net assets (total assets, including cash, minus total liabilities) as on the date of the business contribution into the SPV. In subsequent periods, the historical cost will have to be reduced due to impairment, if any.

Separate financial statements of SPV

- The spin-off balance sheet is made according to the accounting policies applied by KN according to the IFRS, but not according to the principles of accounting of regulated activities.
- Assets and liabilities will be recorded in the separate financial statements of SPV at book values as on the business contribution date. Subsequently, these assets and liabilities will be recorded according to the accounting policies of KN.
- The SPV share capital value shall be determined at the fair value of the business set by an independent valuator. The difference formed in separate financial statements of the SPV between the fair value of the business and the book value of contributed net assets (including the cash amount contributed in addition) will be recorded as a negative reserve. This negative reserve will reduce the SPV's possibility to pay dividend after the spin-off.

Accounting and tax implications of the LNG business spin-off

Contribution of the LNG business as a business complex into SPV (1 of 8)

Steps/actions	No. TGS*	Accounting implications	Tax implications
1. Establishing SPV	2.3.	• A new subsidiary appears in the KN group, which is recorded at historical cost in the separate financial statements of KN. If at the time of establishment this subsidiary is still insignificant, KN will not have to draw up consolidated financial statements yet. • As the SPV business will be significant, after the spin-off KN will have to start preparing consolidated financial statements. They will have to be audited.	• A subsidiary of KN is established – SPV. SPV is a separate taxpayer. The initial authorised capital of the SPV is paid, the SPV is registered with the Register of Legal Entities in the Centre of Registers. • The Centre of Registers registers a new enterprise within 3 business days after filing of documents. It is to be noted in form JAR–1 that the SPV is to be registered in the register of VAT payers. SPV will be registered in the register of taxpayers and in the register of VAT payers within 5 business days after the SPV registration with the Centre of Registers. • When an enterprise is registered as a taxpayer, it is also registered as the employer and data about the enterprise is transferred to the State Social Insurance Fund Board (Sodra). • Sodra must be informed about employment of the SPV head a day before his first working day.
2. Identification of the LNG as assets forming the property complex	1.1.	• The spin-off balance sheet is formed according to the IFRS accounting policy applied by KN, but not according to principles of accounting of regulated activities.	• Assessment of the LNG terminal as a business and of transferred assets and liabilities is performed. For tax purposes, LNG activities would be treated as a separate business, which holds separate objects of ownership, has other business related property and non-property rights, debts and other duties and organisationally constitutes an autonomous economic entity carrying out activities and able to perform its functions at its own discretion.

* Following the business spin-off action plan presented in the TGS report of 19 August 2018.

Contribution of the LNG business as a business complex into SPV (2 of 8)

Steps/actions	No. TGS*	Accounting implications	Tax implications
3. Formation of the LNG spin-off balance sheet	3.1.	• The spin-off balance sheet is formed according to the IFRS accounting policy applied by KN, but not according to principles of accounting of regulated activities. As the spin-off is planned in 2019, evaluation is to be made of additional adjustments to be made upon application of IFRS 16 *Leases* (coming into force on 1 January 2019), including the Company's purchase option to acquire the FSRU at the end of the lease. • Most assets and liabilities are assigned to SPV according to the direct identification method according to the methodology applied in note 5 "Information about segments" to the financial statements of KN. In some items, e.g. intangible assets, taxes on operations, deferred income tax, etc., certain adjustments and appropriation principles are applied in order to correctly reflect the transferred assets and liabilities. • Assignment of cash must also be grounded.	• The spin-off balance sheet identifies all assets and liabilities, differences between individual balance sheet items in financial and tax accounting are reflected. • Actual differences according to the balance sheet of 30 November 2018 – inventory value difference due to impairment and other amounts payable and differences in current liabilities due to accumulated emission allowances. • A separate balance sheet is made according to taxable values, in order to have it clear what taxation values of assets and liabilities are transferred to SPV. • Depreciation of assets transferred along with the LNG business will continue to be calculated for corporate income tax purposes so as it was done in KN before the transfer. Liabilities and accumulations would be transferred together with the whole LNG business.
4. Assessment which employees are to be transferred to SPV	1.3.	• Identification of employee related assets and liabilities (for example, the payable salary and vacation pay reserve) – if legally they are transferred to SPV, such assets and liabilities should also be transferred in accounting (see step 3).	• In performance of the LNG business transfer to SPV, employees related to the LNG activities are transferred together with the payable salary and vacation pay reserve. The taxes payable on the payable salary are not transferred, they remain with KN.

Contribution of the LNG business as a business complex into SPV (3 of 8)

Steps/actions	No. TGS	Accounting implications	Tax implications
5. Transfer of the financing agreements with the EIB and NIB to SPV	3.4.	• KN received some LNG terminal business related loans in 2017, which is later than incurrence of related expenses for investments into the LNG terminal infrastructure. We did not assess correctness and reasonability of assignment of the current loans to SPV.	• Agreements with the EIB and NIB do not provide for transfer of obligations under the loan agreements to another company in case of transfer of the LNG terminal business, but they allow to transfer the LNG terminal business and assets into an SPV wholly controlled by KN, KN remaining the debtor under the agreements. In case not all debt obligations related to the LNG terminal operator's activities were transferred to SPV, there is a risk that the transaction may be re-qualified into a business sale. According to the representatives of the Company, a permission to transfer the said loans into the SPV has been/will be obtained. In such a case, the above risk would not exist.
6. Increase of the authorised capital of SPV by paying newly issued shares with a non-monetary contribution (LNGT business)	4.1.	• The SPV share capital value will be determined by use of the fair value of the business set by an independent valuator. The difference appearing in the separate financial statements of SPV between the fair value of the business and the book value of the contributed net assets (including the additionally contributed cash amount) will be recorded as a negative reserve. This negative reserve will reduce the SPV 's possibility to pay dividend after the spin-off.	• Contribution of the business satisfies the criteria for neutral business contribution established in paragraph 2(6) of Article 41 of the CIT Law, i.e. shares issued by the acquiring entity (SPV) will be given to the transferring entity (KN) and the difference in price will not be paid in cash. • Following paragraph 10 of Article 42 of the CIT Law, the reorganisation will be considered CIT neutral only if KN, upon receipt of the SPV shares, does not sell or transfer the title to them otherwise for at least 3 years. • Sale of the SPV shares would be tax neutral, i.e. exempt according to paragraph 15 of Article 12 of the CIT Law if the SPV shares have been kept for 3 years.

Contribution of the LNG business as a business complex into SPV (4 of 8)

Steps/actions	No. TGS	Accounting implications	Tax implications
6. Increase of the authorised capital of SPV by paying newly issued shares with a non-monetary contribution (LNGT business) (continued)	4.1.		• Transfer of a part of business is not regarded an object of the VAT, i.e. the VAT would not apply. Transfer of the business (or its part) as a complex to another taxable person continuing such business is executed by signing a transfer and acceptance deed of free from. • The acquisition price of the assets taken over by SPV for tax purposes will be equal to the residual tax value of those assets that was on the KN level right before the takeover. • The acquisition price of new SPV shares received by KN will be the tax value of assets and liabilities (i.e. of the net assets) transferred along with the contributed LNG business.
7. Signing of the deed of transfer and acceptance of the LNGT to/by the SPV	4.12.	• Assets and obligations are transferred to the SPV at their book values.	• The transfer and acceptance deed is to indicate the book values (preliminary values) of assets and liabilities according to the spin-off balance sheet as on the date of contribution of the LNG business as a complex and it is expected that the data will be adjusted to reflect the actual situation on the contribution date and relevant residual values (final values) of assets and liabilities.
8. Re-registration of real estate	N/A	N/A	• Following paragraph 1 of Article 3 of the Law of the Republic of Lithuania on the Real Estate Tax, SPV will become subject to the duty to pay the RET from the moment of takeover of the title to real estate.

Contribution of the LNG business as a business complex into SPV (5 of 8)

Steps/actions	No. TGS	Accounting implications	Tax implications
8. Re-registration of real estate (continued)	N/A	N/A	• If the SPV takes over the real estate after 15 December 2018 (the declaration and payment deadline), the duty to pay the RET on the taken over real estate (including the tax payable in advance) will arise only for 2019. • Following the provisions of paragraph 3 of Article 12 of the Law of the Republic of Lithuania on the Land Tax, the land tax is to be paid by a person who was the land owner on 30 June in the taxation period. Consequently, if the SPV takes over and reregisters land plots before this date, it will become subject to the land tax from 2019.
9. Investment project relief	N/A	N/A	• Contributing the LNG business into SPV and alongside transferring such assets, which were subject to the investment project relief, application of such relief can be continued on the SPV level, i.e. the business contribution does not reduce the totally recognised amount of the investment projects relief if the SPV uses the taken over assets until 3 years after the start of use of those fixed assets in KN. • Based on the information presented to us, when contributing the LNG business as a complex into SPV, SPV could take over expenses meeting criteria for the investment project relief incurred in 2015-2018. • SPV could apply the relief and reduce the taxable profit for 2019 and subsequent years until 2022 (if the SPV has taxable profit that can be reduced).

Contribution of the LNG business as a business complex into SPV (6 of 8)

Steps/actions	No. TGS	Accounting implications	Tax implications
10. Tax amounts payable and receivable	N/A	N/A	• The SPV will be given a new taxpayer code, therefore, tax duties will arise only from the date of registration of SPV in the register of taxpayers. • The tax amounts payable and receivable, that are related to the LNG activities in KN, will remain in the KN balance sheet and will not be transferred.
11. Agreement with KN on services necessary for the LNG operator	N/A	N/A	• If any services agreements are made between SPV and KN, following provisions of the CIT Law, such controlled transactions should be performed according to the arm's length principle, i.e. at market prices. The applied transfer pricing will have to be substantiated in KN/SPV transfer pricing documentation.

Contribution of the LNG business as a business complex into SPV (7 of 8)

Steps/actions		Tax implications
12. Rules limiting recognition of interest expenses as allowable deductions	Thin capitalisation rule	• Following Article 40 of the CIT Law and provisions of the Government resolution "Regarding redefinition of income and payments", treating interest as allowable deductions is limited taking into account the thin capitalisation rule. • In cases when loans from related persons or loans guaranteed by related persons exceed the fixed capital of the company at the ratio of 4:1, interest on the excess is treated as non-allowable deductions for tax purposes. This rule does not apply if the company proves that the same loan under the same lending conditions would be granted between independent (unrelated persons). Legal acts do no clearly define whether this corporate income tax anti-avoidance provisions would apply to loans guaranteed by the State. • With regard to the preliminary spin-off balance sheet of 30 September 2018 presented to us and the amount of the authorised capital provided for therein, in SPV the State-guaranteed loans on the balance sheet date will exceed the above ratio and there will be risk that some interest expenses will be treated as non-allowable deductions. This risk can be cancelled in case the authorised capital of SPV is increased up to that corresponding to the 4:1 ratio of fixed capital and loans or if SPV could prove that the same loan under the same lending conditions would be granted between independent (unrelated persons). (based on initial assessment, it looks hardly probable). • As for practical application of the thin capitalisation rule in the SPV situation, we would recommend making an enquiry to the STI requesting an interpretation of provisions of legal acts. If you wish, we could prepare an enquiry and represent the position of SPV during examination of the enquiry.
	30% of the taxable EBITDA rule	• On 1 January 2019, a new interest deduction rule is coming into effect, according to which the amount (part) of interest expenses, exceeding interest income, can be deducted from income, provided such amount does not exceed EUR 3 million. In cases when a company's interest expenses exceed interest income, the amount of interest expenses, exceeding interest income, being no more than 30 percent of the taxable EBITDA, can be deducted from income. • This rule does no apply to loans intended for long-term public infrastructure projects, therefore, in case the LNG terminal business were recognised to be such a project, the risk of limits on interest deductions would be eliminated. • Based on data of the preliminary spin-off balance sheet of 30 September 2018 presented to us, interest paid by SPV (as we were informed by the responsible persons from the Company, the set annual interest rate is 0.5%) will not exceed the limit of EUR 3 million in the nearest future.

Contribution of the LNG business as a business complex into SPV (8 of 8)

Steps/actions	Tax implications
13. Tax implications of the application of IFRS 16 *Leases*	• After IFRS 16 starts to apply from 1 January 2019, the leased FSRU will be treated differently for accounting and tax purposes. Following provisions of paragraph 1 of Article 13 of the CIT Law, assets of an entity are assets owned by the entity or assets received under financial or operating lease contract, providing for the transfer of the ownership right to the entity after the total value of the assets has been paid up. An entity can recognise such assets in tax accounting and deduct the depreciation expenses from the taxable profit. • Currently, the FSRU is leased and lease expenses are recognised as allowable deductions for tax purposes. According to the provisions of IFRS 16, from 1 January 2019 such assets will have to be recognised as fixed assets in financial accounting and recorded in the balance sheet and depreciated during the lease period or the period of useful life, if the value of the assets reflects the reasonably realistic exercise of the option to buy the assets at the end of the lease. Treatment for tax purposes will not change – operating expenses of the lease will continue to be recognised as allowable deductions (as there is no transfer of ownership). • After taking a decision to buy the FSRU at the end of the lease (the FSRU will become the property of SPV), the FSRU will be recognised as fixed assets in tax accounting only after it is bought. This asset will be depreciated during a newly set depreciation period, recognising the depreciation expenses as allowable deductions for the corporate income tax purposes.

Analysis of the LNG business transfer alternatives

Analysis of the LNG business transfer alternatives (1/3)

Tax aspects

Following the agreement between PwC and the Company, please find below an analysis of the possible LNG business transfer alternatives agreed upon with representatives of the Company.

	Alternatives	
Steps	**Transfer (sale) of the LNG as a business**	**Transfer of LNG assets by separate transactions**
1. Identification of the LNG assets, rights and obligations	• Drawing up of the LNG terminal spin-off balance sheet for accounting and tax purposes. Identification and separation of balance sheet items.	• Identification of assets necessary for the LNG activities, making a schedule of transfer transactions.
2. Property valuation	• The transaction will be conducted between related persons, therefore, in order to set the market value of the transferred business and for distribution of the price, two separate valuations by an independent valuator are necessary.	• The transaction will be conducted between related persons, therefore, in order to set the market value of the transferred assets, separate valuations by an independent valuator are necessary.
3. Corporate income tax	• Asset value increase income is subject to 15% corporate income tax.	• Transfer of LNG business by separate transactions is treated for tax purposes as sale of assets, asset value increase income is subject to 15% corporate income tax. • There is a risk that taking into account the entirety of the transactions (the substance over form principle, the general anti-avoidance rule, which will come into force on 1 January 2019), the tax administrator may treat transfer of the activities as the sale of business as a complex. The difference between the profit from sale of the business and the profit from sale of assets can be taxed with 15% corporate income tax.

Analysis of the LNG business transfer alternatives (2/3)

Steps	Alternatives: Transfer (sale) of the LNG as a business	Alternatives: Transfer of LNG activities by separate transactions
4. Depreciation	• After the acquisition, new depreciation terms will be set for separate assets, depreciation will be calculated on the new value of the assets.	• After the acquisition, new depreciation terms will be set for separate assets, depreciation will be calculated on the new value of the assets. • All/some of the LNG activities related obligations and accumulations would remain in KN, therefore, there is a risk that expenses related to them will not be treated as allowable deductions for the corporate income tax purposes as expenses not related to earning of KN income and/or deriving of economic benefit for KN.
5. Value added tax	• In case KN transfers a part of its activities as a complex to another taxable entity, which intends to continue the taken over activities, such transfer will not be treated as a VAT object and will be VAT exempt. SPV should be registered as a VAT payer (or the registration process should be started) at the moment of transfer of the activities. • SPV gets all the obligations in connection with VAT deductions for the taken over assets, i.e. upon change of the circumstances of use of the assets, the SPV will have the duty to make corrections in the VAT deductions. Therefore, it is recommended, in case of transfer of tangible assets, to prepare information on assets acquisition dates, asset improvements, on performed VAT deductions, etc.	• Sale of separate assets would be treated as supply of goods for VAT purposes and would be subject to the VAT at the standard 21% rate if KN deducted the input VAT on those assets (if those assets were manufactured, the input VAT on goods/services used to manufacture them). We would recommend that at the time of transfer of the assets, SPV would already be registered in the register of VAT payers. • The VAT refunds on the SPV level can be delayed from 30 to 60 days. • Another alternative is offsetting of payable and refundable VAT between KN and SPV upon agreement with the STI on the reconciliation procedure provided for in legal acts.

Analysis of the LNG business transfer alternatives (3/3)

Steps	Alternatives	
	Transfer (sale) of the LNG as a business	Transfer of LNG activities by separate transactions
6. Tax goodwill	• In case the amount paid in cash for the LNG activities as a complex (after detailed independent valuation) were more than the value of the LNG net assets part assessed at the fair market price, from which SPV expected certain economic benefit, a tax goodwill may appear, which could be amortised in 15 years.	• N/A
7. Obligations	• LNG related obligations and accumulations would be transferred to SPV.	• Obligations and accumulations could be transferred under bilateral agreements or a tripartite agreement, but that would increase the risk that the STI would recognise the transfer of all the functions as the sale of the business.
8. Employees	• Employees, employment related legal and financial obligations will pass to SPV after the effective date of the LNG sale transaction. The taxes payable in connection with the payable salary will remain in the balance sheet of KN.	• In case KN employee(s) left for SPV, their employment contract(s) with KN would have to be terminated and new employment contract(s) would have to be entered into with SPV. KN would incur additional financial costs in connection with termination of the contracts and compensation for unused vacation.

Analysis of the LNG business transfer alternatives
Accounting aspects

	Alternatives	
	Transfer (sale) of the LNG as a business	**Transfer of LNG activities by separate transactions**
Consolidated financial statements of KN **Separate financial statements of KN** **Separate financial statements of SPV**	• It is probable that the transferred property complex will conform to the business definition according to IFRS 3 *Business Combinations*, therefore, the same principles will apply in accounting, as in case of the business contribution into SPV (see page 11). • As the SPV activities will be significant, after the spin-off KN will have to start drawing up consolidated financial statements. They will have to be audited.	• The IFRS do not regulate transactions of acquisition of a business in stages between companies under common control. In our opinion, similar principles will apply in accounting, as in case of the business contribution into SPV (see page 11). • As the SPV activities will be significant, after the spin-off KN will have to start drawing up consolidated financial statements. They will have to be audited.

Answers to other LNG transfer related questions

Answers to other LNG transfer related questions

Question	Answer and comments
How can the application of IFRS 16 *Leases* from 1 January 2019 affect the spin-off balance sheet and the financial statements of KN and SPV in the coming periods?	After the application of IFRS 16, KN will have to recognise the right to use the leased property as fixed assets and the related operating lease commitment as a financial liability. As the management of the Company actually plans to perform the spin-off of the LNG terminal activities in 2019, this standard will already apply to KN financial accounting. Accordingly, the book value of the transferred assets and liabilities will reflect the IFRS 16 application impact. Please note the following observations: • According to IFRS 16.27.(d), lease payments used in calculation of the said commitment comprise the amount of the option to purchase the leased property at the end of the lease, if the lessee is reasonably certain to exercise that option. • According to IFRS 16.32, recognised assets will have to be depreciated during their useful life if the value of the assets reflects the reasonably certain exercise of the option to purchase the leased property at the end of the lease. As indicated in page 10 of this report, in discussions with the management of the Company and in the information presented in this report, we relied on the confirmations of the management of the Company that the Company is reasonably certain that the FSRU *Independence* will be bought at the end of the lease from Hoegh LNG (in 2024) by exercise of the Company's purchase option provided for in the agreement. The option terms have not been presented to us due to their confidentiality, therefore, we cannot present our exact opinion on the accounting of this option after application of IFRS 16 *Leases*. As lease payments under the agreement with Hoegh LNG are in US dollars, the value of the financial liability calculated according to IFRS 16 in the Company's working currency (the euro) will have to be recalculated in each reporting period according to the official foreign exchange rate as on the balance sheet date and the resulting difference will have to be recognised as profit or loss in the income statement (IFRS 16.BC198). The right to use the assets will be assessed at the foreign exchange rate on the date of transfer to IFRS 16 and will not change later. Therefore, the USD and EUR foreign exchange fluctuations can have a significant effect on the Company's financial statements upon application of IFRS 16. We would recommend that the management of the Company assess this risk.

Annexes

Annex A. Preliminary spin-off balance sheet prepared by the management of the Company

The preliminary spin-off balance sheet of the Company as of 30 September 2018 (xlsx file) is appended as a separate annex to this report.

Abbreviations

Concept	Meaning
Company	AB Klaipėdos nafta
KN	AB Klaipėdos nafta
LNGT	Liquefied natural gas terminal
LNG	Liquefied natural gas terminal in Klaipėda, providing services of liquefied natural gas loading, storage, regasification and supply into the main pipelines
CIT Law	Law on Corporate Income Tax
CIT	Corporate Income Tax
VAT Law	Law on Value Added Tax
VAT	Value Added Tax
RET	Real Estate Tax
STI	State Tax Inspectorate under the Ministry of Finance of the Republic of Lithuania
SPV	Wholly-controlled subsidiary of AB Klaipėdos nafta
IFRS 16	International Financial Reporting Standard 16 *Leases*