Oil and Gas Tax Guide for Russia

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Introduction

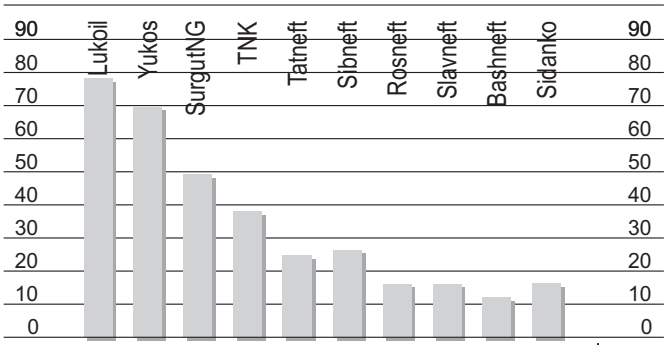
Development of Russia's Oil and Gas Industry

In Russia the oil and gas industry is historically regarded as being one of the most important sectors of the economy, as the revenue it generates forms a major component of the country's budget. The oil and gas industry is currently the main source of the state's tax revenues (about 40 percent of federal budget revenue and approximately 20 percent of the consolidated budget) and currency revenues (about 40 percent). Russia's oil reserves are the third largest in the world after Saudi Arabia's and Iraq's and amount to over 60 billion tonnes. Russia is also a major producer of natural gas, possessing 25 percent of the world's proven reserves.

The development of the Russian oil and gas industry began in the mid-19th century with the development of oil deposits in the Northern Caucasus. The discovery and development of oil and gas deposits in the Volga, Urals, and Timan-Pechora areas led to a significant increase in the volumes of oil extraction in the first half of the 20th century. The development of major basins in Siberia, Timan-Pechora, the Caspian, and the Far East resulted in a record quantity of oil – 557 million tones – being extracted in 1988. Extraction levels fell at the beginning of the 1990s, but are now once again on the increase.

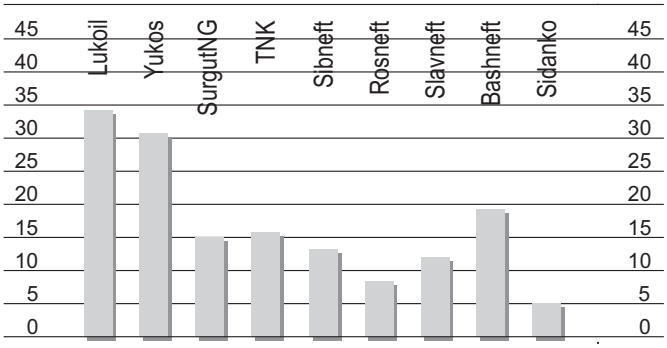
Russia currently has three major groups of regions, which correspond to the initial, intermediate, and final stages of development of the raw material base. At the initial stage of development are deposits in Eastern Siberia, in the Far East (excluding Sakhalin Island), and on the shelves of Russia's seas. The intermediate stage of development is characteristic of deposits in Western Siberia and, in part, the European North (the Timan-Pechora region). At the final stage of development are the "old" extraction regions of Urals-Volga, the North Caucasus, and Sakhalin Island. To date, around 2,000 oil and gas deposits have been explored, of which around 900 are not currently in use. The structure of oil extraction and refinement in the Russian Federation is demonstrated in tables 1 and 2.

Table 1. **Oil Extraction by Russian Oil Companies in 2002 (million tonnes)**



Based on data from the Ministry of Energy of the Russian Federation.

Table 2. **Initial Refinement of Oil by Russian Oil Companies at Their Own Refineries in 2002 (million tonnes)**



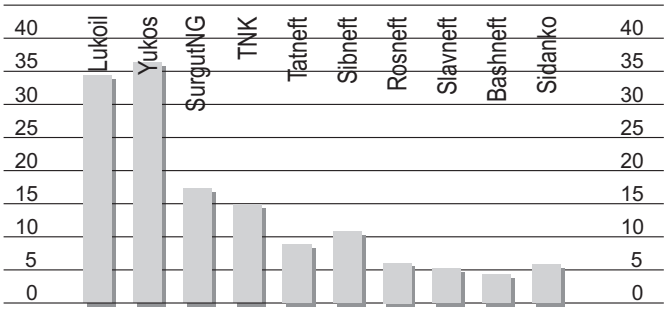
Based on data from the Ministry of Energy of the Russian Federation.

At this stage of development, Russian enterprises engaged in the extraction of products of the oil and gas complex have the advantage of also being refiners (producers) of the raw material in question.

Export

Russia plays a significant part in the formation of world prices owing to the large volumes of oil and gas that Russia supplies to the world market. The Russian oil and gas industry is currently quite influential, which is especially true of the national integrated oil and gas companies formed during the privatisation period of the early 1990s.

Table 3. **Oil Exports by Russian Oil Companies to Countries outside the Former Soviet Union and CIS in 2002 (million tonnes)**



Based on data from the Ministry of Energy of the Russian Federation.

Transportation

Oil transportation is concentrated in the hands of the state monopoly OAO AK Transneft (hereinafter, Transneft), founded in 1993. Transneft owns the majority of pipelines in Russia, extending a total of 49,600 kilometres. Tariffs for oil transportation are established by the state.

Transneft is still state-owned and is generally the owner/operator of new overland pipeline construction projects (e.g., the Baltic Pipeline System and the oil pipeline bypassing Chechnya). Transneft's unique position allows the government to increase revenues to the state budget by changing the tariff. For example, the construction of the Baltic Pipeline System will be financed by a special investment tariff payable by oil-extraction and oil-refining companies using Transneft's transportation services.

The Current State of the Oil and Gas Complex and the Main Parameters for Its Development

According to information from the Ministry of Energy of the Russian Federation, one of the most urgent problems facing Russia's oil industry is rightly considered to be the deterioration of the complex's raw material base, both in quantitative terms (decreasing volume) and qualitative terms (increasing proportion of reserves that are hard to extract).

One of the two main causes is the natural depletion of the inherently finite raw material base at a particular stage of exploitation. This phenomenon was already apparent in the 1980s, but was offset by increased expenditures on exploratory work. The effectiveness of these expenditures decreased steadily with the passage of time. In the 1990s, the progressive depletion of non-renewable hydrocarbon resources and the decreased effectiveness of expenditures on exploratory work were superimposed on an abrupt decline in the level of investment, including investment in exploratory work. It was the combined effect of these two trends that gave rise to the situation we see today: since the end of the 1980s there has been a steady decline in oil extraction, giving way from the mid-1990s to an uneven stabilisation. Gas extraction has been in decline since the beginning of the 1990s.

Since 1994, increases in oil reserves have failed to keep pace with current extraction. The scale of newly discovered deposits has been decreasing not only in developed regions, but also in new prospective areas. The main increases in reserves have derived largely from the further exploration of previously discovered reservoirs and from the reclassification of reserves from "preliminarily appraised" to "explored". The volume of reserves that are written off as unproven is also on the rise.

There is a continuing deterioration in the structure of reserves: The proportion of "difficult" reserves (characterized from the start by lower well-production rates and relatively low oil-withdrawal rates) has now reached between 55 percent and 60 percent and continues to grow. The extraction of residual oil reserves in deposits under development and new reservoirs that are made available requires new technologies and considerably greater expenditures of financial, material, and technical resources than occur under traditional systems of development.

The Russian Oil and Gas Complex in the Context of World Trends

The majority of the world's oil industry is, at present, prepared to operate and develop profitably even with prices at a relatively low level. During the 1980s and 1990s, when world oil prices began to fall, most countries witnessed a consistent decrease in all elements of the price (costs, taxes, profit). The significant decrease in costs (by a world average of approximately 1 US dollar per barrel per year) is explained first and foremost by the intensive use of revolutionary scientific and technical advances, especially in the extraction of the most expensive oil from deep-water marine areas and Arctic regions and involving methods of increasing oil yield, etc. The main decrease in costs has occurred in the extraction of the most expensive hydrocarbons due to the multiplying effect of using such revolutionary technologies as three dimensional seismic surveying, horizontal well drilling, abandonment of the use of fixed marine platforms at great sea depths (i.e., semi-submersibles, guyed-tower platform rigs, and underwater well completion), and the development of computer technologies.

There has been a notable liberalisation in the tax regimes of most oil-extracting countries (flexible taxation, usually with a sliding scale based on the economic efficiency of the development of a deposit, i.e., project-oriented taxation (tax being levied on profit rather than gross receipts)). This ensures that companies earn an acceptable profit and so retain their interest in investing.

Thus, the world's oil industry has successfully assimilated methods of reducing costs through the improvement of technologies, adjustment of tax systems, and institutional changes. All this has substantially widened the price boundaries for various oil extraction regions, enabling them to sell increasing quantities of oil even when prices are low.

In Russia the current situation with respect to the reduction of extraction costs is complicated. In some cases the aggregate cost is prohibitively high: Both Russian and foreign specialists reckon that under the existing system of taxation, the volume of tax charges exceeds the taxable base.

Prospects for Reform

The developing Russian economy needs serious investment in the oil and gas sector. The absence of such investment at the present stage may be attributed to the inadequate legal and fiscal climate and to the high level of political and other

Table 4. **Comparative Assessment of the Tax Regime for Oil-Investment Projects in Various Countries**

Country	Aggregate Tax Burden Relative to Taxable Income, %
Russia	
Current tax regime	104%
PSA regime	68%
Indonesia	89%
Abu Dhabi	88%
Venezuela	87%
Oman	85%
Norway	83%
Libya	77%
Angola	73%
USA	
Alaska	66%
Other states	55%
Canada	53%
Great Britain (North Sea)	30%

Based on data from the Ministry of Energy of the Russian Federation.

corporate risks. As the state of the Russian oil and gas industry is in constant flux, we recommend contacting Ernst & Young experts before taking any action in regard to the provisions of tax legislation or the relevant commentaries presented in this brochure. This brochure deals only with the general rules for the application of tax legislation and is not intended to describe all the practical taxation issues with which enterprises in the oil and gas industry may be confronted.

Legal Aspects of the Activities of Oil and Gas Companies

Legislative Foundations

Under Russian legislation, natural resources, including oil, gas, precious metals and minerals, underground waters, and other commercial minerals situated within the territory of the Russian Federation are the property of the state. The right to possess, use, and dispose of subsurface resources is under the joint authority of the Russian Federation and its constituent entities. Subsurface resources cannot be bought, sold, gifted, inherited, pledged, or alienated in any other way. At the same time, the right to use subsurface resources may be

alienated or transferred from one person to another in cases permitted by federal legislation.

At present, oil- and gas-extraction companies in Russia may operate on the basis of the law "Concerning Subsurface Resources" (1992), which establishes the rights and obligations of users of subsurface resources and of the state; the law "Concerning Production Sharing Agreements" (1995); and other normative acts governing relations associated with the use and protection of land, water and the environment which arise in connection with the use of subsurface resources.

The Law "Concerning Subsurface Resources"

The law "Concerning Subsurface Resources" regulates relations arising in connection with the geological study, use, and protection of subsurface resources within the territory of the Russian Federation. Pursuant to the law, subsurface resources may be developed only on the basis of a licence. The licence contains information on the site to be developed, the period of activity, financial conditions, etc. In addition to payments for the right to use subsurface resources, companies operating on the basis of a licence must pay other generally established taxes, such as profits tax, VAT, etc.

The Law "Concerning Production Sharing Agreements"

The law "Concerning Production Sharing Agreements" establishes that the extraction of mineral resources and other relevant activities are to be regulated by a particular special agreement to be concluded between a company (the investor) and the state. Such an agreement, essentially a contract between the state and the investor, regulates taxation, currency, and customs issues in detail and helps to ensure stability in these areas. In the context of constantly changing tax legislation, product sharing agreements are intended to serve as an effective instrument for attracting foreign investments.

Licensing

Under the law "Concerning Subsurface Resources," licences may be granted to both Russian and foreign legal entities. In particular, a licence is required for the following types of activity:

- Regional geological study.
- Geological study, including the exploration and appraisal of commercial-mineral deposits.
- Prospecting for and extraction of commercial minerals.
- Development of commercial-mineral deposits, use of mining waste, and related processing work.
- Use of subsurface resources for purposes unrelated to the extraction of commercial minerals.

Subsurface resources may be simultaneously provided for use in geological study (exploration, prospecting) and the extraction of commercial minerals. A licence holder has the exclusive right to develop and extract commercial minerals on the deposit specified in the licence.

The provision of a site of subsurface resources for use under a PSA is documented by a licence to use subsurface resources. The licence certifies the right to use that site, subject to the terms of the agreement, which sets out all essential conditions of use of the subsurface resources. Sites of subsurface resources are provided for the following purposes and periods:

- Geological study – for a period of up to five years.
- Extraction of commercial minerals – for the period required to develop the deposit, as calculated on the basis of a feasibility study on the deposit's exploitation, which provides for the rational use and protection of subsurface resources.

The period of use of a site of subsurface resources may be extended as required if a commercial-mineral deposit has yet to be fully developed. The procedure for extending the period of use of a site of subsurface resources under a PSA is determined by that agreement.

Under legislation concerning subsurface resources, an agreement may be concluded between authorised state bodies and a user of subsurface resources to establish the terms of use of that site and the parties' obligations under the agreement. The specific features and characteristics of the tax treatment of product sharing agreements will be examined in the chapter entitled "Special Tax Regimes for the Oil and Gas Industry."

Taxation of Companies in the Oil and Gas Industry

Extraction and refining companies are subject to profits tax and VAT in accordance with general taxation procedures, in addition to all specific taxes and allocations established for oil- and gas-extraction enterprises in the Tax Code, the law "Concerning Subsurface Resources," and other legislative acts. Enterprises in the oil- and gas-extraction industry thus bear an additional tax burden as compared with enterprises in other industries.

This chapter describes the tax regime effective in Russia from January 1, 2003.

Payments for the Right to Use Subsurface Resources

Under current legislation, the following system of payments applies in connection with the use of subsurface resources:

- One-time payments for the use of subsurface resources.
- Regular payments for the use of subsurface resources.
- The charge for geological information on subsurface resources.
- The fee for participation in a competitive tender (auction).
- The fee for the issue of licences.

The procedure and rates of payment for the use of subsurface resources and the conditions for the collection of such payments under product sharing agreements are established by those agreements.

All legal entities engaged in exploration, prospecting, and extraction of commercial minerals within the territory of the Russian Federation, its continental shelf and its maritime exclusive economic zone are required to make these payments.

One-Time Payments for the Use of Subsurface Resources. One-time payments for the use of subsurface resources are levied in connection with certain events specified in the licence. The minimum rates of one-time payments are established at not less than 10 percent of the amount of tax on the extraction of commercial minerals, as calculated based on the average annual projected capacity of an extraction organisation. One-time payments are to be made in accordance with the procedure established in the licence. The rates of one-time payments for the use of subsurface resources and the procedure for making such payments under product sharing agreements are to be established in the production-sharing agreement.

Regular Payments for the Use of Subsurface Resources. Regular payments are levied on users of subsurface resources in exchange for exclusive rights to explore and appraise deposits of commercial minerals, prospect for minerals, carry out geological studies, and assess the suitability of sites of subsurface resources for the construction of facilities not associated with the extraction of commercial minerals (with the exception of shallow-lying engineering facilities). Regular payments are not charged for:

- The use of subsurface resources for regional geological study.
- The use of specially protected geological sites for scientific, cultural, recreational, and other purposes established by legislation.
- The use of subsurface resources for the collection of mineralogical, palaeontological, and other geological specimens.
- Other uses of subsurface resources established by law.

The rates of regular payments for the use of subsurface resources are determined on the basis of economic and geographic conditions, the size of the site of subsurface resources, the type of commercial mineral, the duration of work, the degree of previous geological study of the area, and the level of risk. Payment is made quarterly based on the area of the licensed site granted to a user of subsurface resources, less the returned portion of the licensed site.

The rates of regular payments for the use of subsurface resources and the conditions and procedure for collecting such payments under product sharing agreements are to be established by the product sharing agreements within the limits established by the government of the Russian Federation.

Charge for Geological Information on Subsurface Resources. There is a charge for the use of geological information obtained from the relevant federal body. The charge for this information and the procedures for paying it are established by the government of the Russian Federation. The rate of this charge under a production-sharing agreement is to be established in the agreement itself.

Tax on the Extraction of Commercial Minerals

This tax, implemented by federal Law No. 126-FZ on January 1, 2002 (Chapter 26 of the Russian Tax Code), is levied on commercial minerals extracted from the subsurface within the territory of the Russian Federation. The tax base is determined as the value of extracted commercial minerals, as calculated based on the volume of extracted commercial minerals and the applicable valuation method.

Taxpayers are entitled to determine the quantity of an extracted commercial mineral using two methods: the direct method (using measuring instruments and devices) or the indirect method (based on indicators of the level of the extracted commercial mineral contained in mineral raw materials extracted from the subsurface). But it should be noted that the direct method has priority, as the indirect method may be applied only when it is impossible to use the direct method.

Commercial minerals may be valued according to the following methods:

- On the basis of the sale prices prevailing for the taxpayer in the tax period in question, excluding state subsidies to cover the difference between the wholesale price and the calculated value of the mineral raw materials.
- On the basis of the sale prices prevailing for the taxpayer in the tax period in question, less VAT, excise duty on excisable types of mineral raw materials, customs duties, transportation costs, and insurance contributions for compulsory freight insurance.
- On the basis of the value of the extracted commercial minerals, as calculated based on data from tax records maintained in accordance with the rules established by Chapter 25 of the Russian Tax Code, "Tax on the Profit of Organisations" (where it is impossible to use one of the preceding methods).

The tax rate for oil, gas condensate, and natural gas is set at 16.5 percent of the taxable base. A zero tax rate is applied for associated gas and normative losses of commercial minerals.

During the period from January 1, 2002 through December 31, 2004, legislation stipulates that transitional provisions apply for the taxation of oil and gas condensate extracted from oil and gas deposits. During this period, the taxable base for tax on the extraction of commercial minerals is to be determined as the quantity of extracted oil in physical terms at a rate of 340 roubles per tonne. In this connection, the tax rate is to be adjusted quarterly by a coefficient reflecting the movement in world prices for Urals-grade oil.

This coefficient is determined independently by the taxpayer on a quarterly basis in accordance with the formula:

$$Cf = (P - 8) \times R / 252,$$

where **P** is the average price per barrel in US dollars for Urals-grade oil during the tax period, and **R** is the average value of the US dollar against the Russian rouble during the tax period, as determined by the Central Bank of the Russian Federation.

Tax on the extraction of commercial minerals under product sharing agreements is to be calculated taking into account the provisions of the law "Concerning Production Sharing Agreements" and Chapter 26 of the Tax Code.

Excise Duties in the Oil and Gas Industry

Excise Duties on Natural Gas. In accordance with Chapter 22 ("Excise Duties") of the Russian Tax Code, natural gas is an excisable mineral raw material. The tax base on the domestic market is determined as the value of transported natural gas which has been sold (transferred), as calculated based on the applicable prices, taking into account discounts granted in accordance with the established procedures, less value added tax. Where payment is made for services involving the transportation of gas via gas-distribution networks, the cost of those services and the amount of tariffs are not included in the tax base.

When natural gas is sold beyond the borders of the Russian Federation, the tax base is determined as the value of natural gas sold, less customs payments and expenses for the transportation of natural gas outside the territory of the Russian Federation.

Where gas is sold to countries within the Commonwealth of Independent States (hereinafter "CIS"), the tax base is reduced by the amount of value added tax. For the purposes of calculating and paying excise duty on natural gas, the date of sale of natural gas is the day on which payment is made for this excisable mineral raw material.

Exemption from Tax. Chapter 22 of the Russian Tax Code establishes a list of non-taxable operations involving natural gas. These include:

- The injection of natural gas into a formation to maintain formation pressure.
- The injection of natural gas into underground storage facilities.
- The use of natural gas for the preparation of heat carriers for injection into oil reservoirs and for other methods of increasing oil and gas yield as well as for gas-lift oil extraction.
- The use of natural gas for the internal operating requirements of gas-extraction and gas-transportation organisations within norms dependent upon the technologies for the preparation and transportation of gas and approved in accordance with a procedure to be determined by the government of the Russian Federation.
- The sale (transfer), within the territory of the Russian Federation, of dry stripped gas and petroleum (associated) gas after treatment or processing.
- The sale within the territory of the Russian Federation of natural gas intended for personal consumption by physical persons and for consumption by housing-construction co-operatives, condominiums, and other similar consumers.
- The transfer and/or sale of natural gas for the production (including on the basis of customer-supplied materials) of compressed gas, where such gas is sold at state-regulated prices.

Chapter 22 makes the tax-exempt status of the above operations strictly conditional on the maintenance and possession of separate records of the production and sale of the mineral raw material in question.

Operations constituting the tax base for natural gas are not subject to excise duties if excisable types of mineral raw materials were extracted (produced) outside the territory of the Russian Federation, its continental shelf, and/or its exclusive economic zone.

Under production-sharing agreements, excise duties are calculated in accordance with the norms of the federal law "Concerning Production Sharing Agreements" and Chapter 22 of the Tax Code.

Excise Duties on Petroleum Products. Federal laws 110-FZ of July 24, 2002 and 191-FZ of December 31, 2002 amended Chapter 22 ("Excise Duties") of the Tax Code of the Russian Federation. The amendments, which entered into force on January 1, 2003, introduced a new procedure for the taxation of operations involving excisable petroleum products. Whereas in the past excise duties were levied mainly in connection with the sale of petroleum products and/or the transfer of customer-supplied raw materials to the owner, from January 1, 2003 excise duties apply to operations involving the receipt of petroleum products. In other words, the organisation receiving excisable petroleum products is required to calculate and pay excise duties rather than the organisation that sells such products. At the same time, taxpayers acquire the right to deduct excise duty upon receipt of a certificate of registration of an entity carrying out operations with petroleum products, as issued by the tax authorities.

Table 5. **Excise Rates**

Types of Excisable Mineral Raw Materials	Excise Rate, %
Natural gas sold (transferred) within the territory of the Russian Federation	15%
Natural gas sold (transferred) to member states of the CIS	15%
Natural gas sold (transferred) outside the territory of the Russian Federation (to the far abroad)	30%

Certificate of Registration of an Entity Carrying Out Operations with Petroleum Products. Certificates of registration of an entity carrying out operations with petroleum products are issued to taxpayers engaged in the following types of activity:

- The production of petroleum products – a production certificate.
- The wholesale sale of petroleum products – a wholesale sale certificate.
- The wholesale and retail sale of petroleum products – a wholesale-retail sale certificate.
- The retail sale of petroleum products – a retail sale certificate.
- Certificates are to be issued subject to the following requirements:
- A production certificate – on condition that the organisation or private entrepreneur owns facilities for the production, storage, and supply of petroleum products.
- A wholesale sale certificate – on condition that the organisation or private entrepreneur owns facilities for the storage and supply of petroleum products.
- A wholesale and retail sale certificate – on condition that the organisation or private entrepre-

neur owns facilities for the storage and supply of petroleum products and fixed fuel-dispensing pumps.

! A retail sale certificate – on condition that the organisation or private entrepreneur owns facilities for the storage and supply of petroleum products from fixed fuel-dispensing pumps.

It should be noted that the right to obtain a certificate is enjoyed not only by an organisation that owns the appropriate facilities, but also by an organisation that owns more than 50 percent of the charter (pooled) capital or more than 50 percent of the voting shares of such an organisation.

Legal entities without the appropriate certificates are not entitled to deduct charged amounts of excise duty.

Amounts of excise duty calculated upon receipt of petroleum products by a taxpayer having a production certificate and/or wholesale sale certificate and/or wholesale and retail sale certificate, where such products are sold (transferred) to a taxpayer with a certificate, are deductible upon submission of the required documents. Amounts of excise duty calculated by a taxpayer having a certificate for the retail sale of petroleum products, where excise tax is calculated upon receipt of petroleum products for retail sale, are not deductible. The supply of petroleum products from fuel-dispensing pumps is regarded as the retail sale of petroleum products.

Excise duty is to be paid not later than the twenty-fifth of the month following the elapsed tax period. The tax period is one calendar month. Taxpayers possessing only a wholesale sale certificate, however, are to pay excise duty not later than the twenty-fifth of the second month following the elapsed tax period, and taxpayers having only a retail sale certificate are to pay excise duty not later than the tenth of the month following the elapsed tax period.

Table 6. **Comparative Analysis of Excise Rates for Certain Petroleum Products in 2002 and 2003**

Type of Petroleum Product	Tax Rate in Effect in 2002 (roubles per tonne)	Tax Rate in Effect from January 1, 2003 (roubles per tonne)
Automobile petrol with octane numbers up to and including 80	1,512	2,190
Automobile petrol with other octane numbers	2,072	3,000
Diesel fuel	616	890
Directly distilled petrol	Not excisable	0

Excisable operations with oil products are exempt from taxation, providing that these oil products have been placed under the export customs regime.

Profits Tax

General. From January 1, 2002 the procedure for calculating and paying profits tax is regulated by Chapter 25 ("Tax on the Profits of Organisations") of the Tax Code of the Russian Federation. Under Chapter 25 of the Tax Code, organizations and entrepreneurs carrying out entrepreneurial activities in Russia are required to pay profits tax. Profits tax is one of the main budget-forming taxes and a significant payment from the point of view of the financial management of organizations and entrepreneurs. Changes in the structure of this tax are thus of interest to tax authorities and taxpayers alike.

Profits tax is levied on profit in the form of income received, minus expenses incurred, as determined in accordance with the provisions of Chapter 25 of the Tax Code.

Tax Accounting. For profits tax purposes, organisations and entrepreneurs determine the tax base from the results of each accounting (tax) period, based on tax accounting data.

Tax accounting is a system of integrating information to determine the tax base using data from primary documents grouped in accordance with the procedure stipulated in Chapter 25 of the Tax Code.

If the account books contain insufficient information for a determination of the tax base in accordance with the requirements of Chapter 25 of the Tax Code, organisations and entrepreneurs (payers of profits tax) are entitled to independently supplement the account books with additional details, thus contributing to the formation of the account books, or to keep independent account books. An important provision is that taxpayers participate independently in the process of forming tax records, taking into account the taxpayer's specific type of activity. The taxpayer determines a tax accounting procedure in its accounting policy for taxation purposes, as approved by the relevant order (regulation) of the director. Tax and other authorities are not entitled to stipulate mandatory forms of tax accounting documents for taxpayers.

Tax accounting data should reflect the procedure for forming income and expenses, the procedure for determining the proportion of taxable expenses in the current tax (accounting) period, the balance of expenses (losses) to be treated as ex-

penses in subsequent tax periods, the procedure for forming reserves, and the balance of tax owed to the budget.

Income and Expenses. Chapter 25 of the Tax Code envisages two methods of determining income and expenses: the "accrual method" and the "cash method".

Under the accrual method, income and expenses are recognized in the accounting (tax) period in which they arise, irrespective of whether money, other assets (work, services), and/or property rights are in fact received. In the case of income relating to several accounting (tax) periods, and where the link between income and expenses cannot be clearly established or is established indirectly, income is allocated independently by the taxpayer, taking into account the principle of even recognition of income and expenses.

Under the cash method, organisations (with the exception of banks) are entitled to determine the date on which income is received (expenses are incurred) using the cash method if, over the previous four quarters, earnings from the sale of these organisations' goods (work, services), excluding value added tax and sales tax, did not on average exceed one million roubles per quarter. For the purposes of this chapter, the date on which income is received is regarded as being the day on which funds are received on bank accounts and/or by the cashier's office, or other assets (work, services) and/or property rights are received, or a debt to a taxpayer is settled in another manner (the cash method). Expenses under this method are recognised after they have actually been paid. Payment for goods (work, services, and/or property rights) is regarded as being the termination of the reciprocal obligation of the acquirer of such goods (work, services) and property rights to the seller directly associated with the supply of said goods (performance of work or services, transfer of property rights).

For tax accounting purposes, expenses are divided into direct and indirect expenses relating to production and sales and direct and indirect expenses relating to trade operations.

Direct expenses relating to production and sales include material expenses, payroll expenses with respect to personnel participating in the goods-production process, and amounts of amortisation calculated on fixed assets. All other expenses, with the exception of non-sales expenses incurred by a taxpayer in the accounting (tax) period, are treated as indirect expenses. In this regard, indirect expenses for production and sales incurred in the accounting (tax) period are included in full in expenses of the current accounting (tax) period. Direct expenses incurred in the accounting (tax) period are also included in expenses of the current accounting (tax) period, with the exception of direct expenses allocated to balances of work in progress, finished products in stock, and products dispatched but not sold in the accounting (tax) period.

In the case of wholesale, small wholesale and retail trade, direct expenses include the cost of purchase goods sold in the given accounting (tax) period and expenses (transportation expenses) for the delivery of purchase goods to the warehouse of the taxpayer purchasing the goods in the event that such expenses are not included in the acquisition price of the goods. All other expenses incurred in the current month, with the exception of non-sales expenses, are treated as indirect expenses and used to reduce sales revenue for the current month. The amount of direct expenses relating to balances of goods in stock is determined on the basis of the average percentage for the current month, taking into account the balance carried over at the beginning of the month.

Amortisation. Amortisable assets are understood to mean assets, results of intellectual activity, and other intellectual property assets owned by a taxpayer (taking into account other provisions of the Tax Code) and used by said taxpayer for the purpose of deriving income, where the value of such assets is written off by means of calculating amortisation. Amortisable assets are assets with a service life of more than 12 months and a historical cost of more than 10,000 roubles.

Land and other natural-resource sites (water, subsurface resources, and other natural resources), inventory, goods, capital-construction projects in progress, securities and term-transaction financial instruments including forward, futures, and option contracts) are not subject to amortisation.

Amortisable assets are allocated to amortisation groups in accordance with their useful life. Useful life is understood as being the period during which a fixed asset or intangible asset serves the purposes of a taxpayer's activities, e.g., the first group – all short-life assets with a useful life of from one to two years, inclusively; the fifth group – assets with a useful life of over seven years and up to 10 years, inclusively;

and the tenth group – assets with a useful life of over thirty years. The useful life shall be determined independently by a taxpayer as of the date on which the amortizable asset in question is put

into exploitation in accordance with the provisions of this article and taking into account the classification of fixed assets approved by the government of the Russian Federation. A taxpayer is entitled to increase the useful life of a fixed asset after the date on which it is put into exploitation if its useful life has increased following the reconstruction, modernisation, or retooling of said asset. The useful life of a fixed asset may be increased within the time limits established for the amortisation group in which the fixed asset was previously included.

For taxation purposes, taxpayers determine the amount of amortisation on a monthly basis in accordance with the procedure established in this article. Amortisation is charged separately for each amortisable asset.

For profits tax purposes, amortisation is calculated using one of the following methods, taking into account the provisions of the Tax Code: 1) the linear method; 2) the non-linear method.

For buildings, installations, and transmitters included in the eighth to tenth amortisation groups, irrespective of when they were commissioned, the linear method of calculating amortisation is used exclusively.

Where the linear method is used, the amount of amortisation calculated for one month on an amortisable asset is determined as its historical (replacement) cost multiplied by the amortisation rate for that asset. Where the nonlinear method is used, the amount of amortisation calculated for one month on an amortisable asset is determined as its net book value multiplied by the amortisation rate for that asset. In this connection, beginning with the month following that in which the net book value of an amortizable asset reaches 20 percent of the historical (replacement) cost of that asset, amortisation should be calculated as follows: for amortisation purposes, the net book value of the amortisable asset is made the base value for subsequent computations, and the amount of amortisation calculated for one month on the amortisable asset in question is determined by dividing the base value of that asset by the number of months remaining until the expiration of the asset's useful life.

Example. Classification of Certain Fixed Assets in the Oil and Gas Sector by Amortisation Group

Fixed Assets	Amortisation Group
Tongs; fishing tools for rectification of drilling accidents; tools and devices for sidetracking; drilling tools (other than rock destruction tools); tools for screwing and unscrewing and suspension of tubing and rods during repairs to development wells; fishing tools for development wells; tools for drilling expendable wells; other tools for oilfield and geological prospecting equipment	First group (from one to two years)
Oilfield and exploratory drilling equipment	Third group (over three and up to five years inclusively)
Drilling rigs for development and deep-well exploratory drilling	Fourth group (over five and up to seven years)
Development oil well	Sixth group (over ten and up to fifteen years inclusively)
Tank farm	Ninth group (over twenty five and up to thirty years)

Tax Rate. The rate of profits tax is set at 24 percent of the taxable base. From January 1, 2003 the proportions payable to federal, regional, and local budgets are 6 percent, 16 percent, and 2 percent, respectively. The legislative bodies of constituent entities of the Russian Federation are entitled to lower the tax rate for certain categories of taxpayers as regards tax payable to the budgets of constituent entities of the Russian Federation, but not by more than 4 percent. The minimum tax rate is thus 20 percent.

Taxation of Foreign Organisations. Foreign legal entities carrying out entrepreneurial activities in Russia through a permanent establishment are taxed on profits attributable to the foreign legal entity's activities in Russia under Chapter 25 of the Tax Code. A permanent establishment of a foreign organisation in the Russian Federation is understood to mean a branch, office, other economically autonomous subdivision, or other place of business through which the organisation carries out entrepreneurial activities on a regular basis within the territory of the Russian Federation in accordance with Chapter 25 of the Tax Code. Foreign organisations doing business in the Russian Federation through a permanent establishment are taxed at a rate of 24 percent.

Withholding Tax. Withholding tax is applicable to income not attributable to activities through a permanent establishment and received by a foreign company from sources in the Russian Federation. The following types of income received by a foreign organisation and unrelated to its entrepreneurial activities in the Russian Federation are subject to withholding tax:

- Dividends.
- Income received as a result of the distribution of profits or assets of organisations or associations thereof to foreign organisations.

- Interest income from debt obligations of any kind.
- Income from the exercise in the Russian Federation of rights to intellectual property of any kind.
- Income from the sale of shares in accordance with Chapter 25 of the Tax Code.
- Income from the sale of immovable property situated within the territory of the Russian Federation.
- Income from the leasing or subleasing of assets used within the territory of the Russian Federation.
- Income from international carriage.
- Fines and penalties for the violation by Russian entities (state bodies) of contractual obligations.
- Other similar income.

The tax rates for income of foreign organisations not associated with activities in the Russian Federation through a permanent establishment are as follows:

- 20 percent on any income other than income from dividends and certain types of debt obligation.
- 10 percent on income from the operation, maintenance, or rental (chartering) of vessels, aeroplanes or other mobile means of transport or containers (including trailers and auxiliary equipment required for transportation) in connection with international traffic.

The following rate applies to the tax base determined for income received in the form of dividends:

- 15 percent for income received in the form of dividends from Russian organisations by foreign organisations.

A number of international double taxation treaties concluded by Russia with other states prescribe special taxation rules and take priority over domestic legislation. Some treaties provide for a reduction of withholding tax to 0 percent.

Tax on the Profits of Oil and Gas Companies. Taxpayers that have decided to obtain licences to use subsurface resources are to separately reflect expenses incurred for the purpose of obtaining licences in analytical tax ledgers. Expenses relating to the acquisition of each individual licence are to be recorded separately. Chapter 25 of the Tax Code specifies two types of expense in connection with the development of natural resources: expenses incurred for the purpose of obtaining a licence and expenses for the development of natural resources.

Expenses incurred for the purpose of obtaining a licence include expenses involved in performing an audit of deposit reserves, expenses for the acquisition of geological and other information, and expenses for participation in a competitive tender. If, based on the results of a tender, a taxpayer concludes a licence agreement for the right to use subsurface resources (obtains a licence), expenses incurred by the taxpayer

in connection with its participation in the tender are included in the value of the licence agreement (licence), which is to be recorded by the taxpayer as an intangible asset.

Expenses for the development of natural resources include: (1) expenses for the exploration and appraisal of deposits of commercial minerals (including an audit of reserves), prospecting for commercial minerals and/or hydrogeology surveys; (2) expenses involved in preparing an area for mining, construction, and other work in accordance with the established requirements in respect of safety, conservation of land, subsurface resources, and other natural resources, and environmental protection; (3) expenses in the form of compensation for comprehensive damage done to natural resources by land users in the process of constructing and utilising facilities; and (4) others.

Expenses for the development of natural resources are recorded separately in the analytical tax ledgers for each site of subsurface resources reflected in the licensing agreement. At the same time, depending on the specific type of activity, expenses are grouped as: (1) general expenses for the site being developed; (2) expenses relating to individual parts of a site under development; and (3) expenses relating to a specific facility created in the process of site development.

General expenses are recorded for each part of a deposit (site) under development in a proportion determined based on the ratio of expenses relating to the individual parts of the site to the total expenses incurred for the development of the site (deposit) in question.

Current expenses for the maintenance of facilities associated with the development of natural resources (including payroll expenses, expenses in connection with the maintenance and operation of temporary structures, and similar expenses), as well as expenses for supplementary exploration of a deposit or areas thereof located within an or-

ganisation's mining or land allotment, are included in full in expenses of the accounting (tax) period in which they were incurred. In this connection, expenses for supplementary exploration include expenses associated with the supplementary exploration of deposits that have been put into exploitation and commercially developed.

For tax purposes, expenses for the development of natural resources – including expenses for constructing (drilling) exploratory wells that prove non-productive on oil and gas fields and for performing a range of geological work and testing involving such wells, as well as for the subsequent liquidation of wells – are to be recognised for tax purposes evenly over 12 months from the first of the month following the month in which such a well was liquidated in accordance with the established procedure as having fulfilled its purpose. Such a procedure may be used by a taxpayer, irrespective of whether work on the relevant site of subsurface resources is continued or terminated after a non-productive well has been liquidated, on condition that expenses on this well are accounted for separately. The decision to declare a well non-productive is made once by a taxpayer and may not subsequently be altered. In this connection, the taxpayer is to notify the tax authority for its place of registration of the decision taken in regard to each well not later than the submission deadline set by Chapter 25 for a tax declaration for the accounting (tax) period in which the taxpayer actually included the expenses (portion of such expenses) on the well in "other expenses".

Value Added Tax (VAT)

General. Oil, gas, and oil products sold on the Russian market are liable to value added tax at a rate of 20 percent. What is payable to the budget is the difference between amounts of tax charged to purchasers of products and tax paid to suppliers for goods (work and services) used for production requirements. Advances received against future supplies of goods (work and services) are also taxable and subject to inclusion in the tax base for VAT purposes. On the basis of sales results, amounts of advances already paid should be deducted from the total amount of tax in accordance with the Tax Code.

Exports. Operations involving the export of oil and gas (with the exception of CIS countries), including transportation and shipment, are liable to VAT at the rate of 0 percent. VAT paid to suppliers of goods for export is reimbursable.

In the case of oil and gas supplied to CIS countries, the "country of origin" principle remains in place, i.e., tax is levied according to the standard procedure at a rate of 20 percent.

VAT paid for inventory (work, services) to suppliers participating in the production and sale of export goods may be claimed for deduction against other tax liabilities or reimbursed in accordance with the Tax Code. It must be kept in mind that the tax is reimbursable on condition that the company keep separate accounts of expenses for export operations and operations on the domestic market. Current legislation does not provide a clear definition of separate accounting, and taxpayers are thus entitled to set their own rules with respect to separate accounting for expenses in their accounting policy.

Imports. Imported petroleum products are taxable at a rate of 20 percent. At the same time, VAT is not levied on oil, stable gas condensate or natural gas imported into the territory of the Russian Federation from the territories of countries of the CIS.

Payment of VAT for Foreign Legal Entities. Russian VAT legislation stipulates that, where goods (work and services) are sold within the territory of the Russian Federation by foreign organisations not registered with the tax authorities, VAT is to be paid by Russian organizations out of resources transferred to the foreign organisations. In this instance, the Russian organisation acts as a tax agent in relation to the foreign organisation. The tax base is determined as the amount of income from the sale of goods (work and services), including tax. Amounts of tax paid to the budget by the Russian organisation in its capacity as a tax agent are tax-deductible (reimbursable).

International Agreements on Indirect Taxes. Russia has ratified a number of agreements and protocols in regard to the collection of indirect taxes. Agreements with Kyrgyzstan, Azerbaijan, Kazakhstan, and Armenia establish reductions or exemptions from the payment of indirect taxes.

In addition, on July 1, 2001, Russia converted to the "country of destination" principle for calculating tax on all goods exported from the territory of the Russian Federation – with the exception of oil, including stable gas condensate, and natural gas – exported to the territories of CIS member states.

Customs Duties

Customs duties are currently levied on exports of oil, natural gas, gas condensate, and oil products. The duty rates for crude oil are established by the government of the Russian Federation on the basis of world oil prices. Customs duties on oil products may not exceed 90 percent of the minimum level of customs duty established for crude oil.

Export-import operations are subject to levies for customs clearance, which are calculated as a percentage of the customs value of exported or imported goods and raw materials. In accordance with the customs legislation of the Russian Federation, goods may be placed under the temporary import regime, whereby imported goods and equipment are wholly or partially exempted from customs duties, VAT, and excise duties, provided that those goods and equipment are exported from the territory of the Russian Federation when the temporary importation period expires.

Other Corporate Taxes

The following corporate taxes are also in effect within the territory of the Russian Federation in 2003:

- Unified social tax.
- Assets tax.
- Advertising tax.
- Transport tax.
- Sales tax.
- Unified tax on imputed income (as a special tax regime).
- Other taxes and levies in accordance with the Tax Code of the Russian Federation.

Special Tax Regimes in the Oil and Gas Industry

Production Sharing Agreements (PSAs)

What Is a PSA. A PSA is an agreement under which the state grants an investor, on a chargeable basis and for a specified period of time, exclusive rights to engage in exploration, prospecting, and extraction of mineral raw materials on a particular site of subsurface resources. In turn, the investor is obliged to carry out that work within the agreed time limits at its own expense and risk.

The PSA law[1] establishes that extracted production, less compensatory production, will be transferred to the investor as compensation for expenditures on work performed under the agreement. The profit part of production (all extracted production, less compensatory production) is to be shared between the investor and the state. It is envisaged that the sharing of production, including determination of the proportion of compensatory production, should be stipulated by the terms of each individual agreement.

In addition to the PSA law, this system of use of subsurface resources is also regulated by a number of other legislative acts, which establish a list of expenditures that are reimbursable out of compensatory production and the procedure for collecting payments for the use of subsurface resources, excise duties, and other taxes and levies. These documents do not, however, regulate all aspects of the application of the production-sharing regime, and the specific nature of the terms of performance of PSAs must therefore be agreed between the investor and a government commission and set out in detail in the text of each agreement.

Parties to a PSA. Under the PSA law, the parties to an agreement are the state on the one hand and one or more investors on the other. The state is represented in PSAs by the government of the Russian Federation and the executive body of the constituent entity of the Russian Federation in whose territory the site of subsurface resources provided for use is situated. The following legal entities and physical persons may be investors under current Russian legislation:

- Citizens of the Russian Federation.
- Foreign citizens.
- Legal entities.
- Associations of legal entities not having legal-entity status.

One of the most important aspects of the conclusion of PSAs is the investors' selection of the type of structure and organization of activities for the implementation of the PSA. Each type has its advantages and disadvantages, and a detailed analysis is thus necessary for each individual agreement.

The Procedure for Concluding a PSA in the Russian Federation. Pursuant to the PSA law, not more than 30 percent of commercial-mineral reserves that have been explored and included

[1] Federal Law No. 225-FZ of December 30, 1995 "Concerning Production Sharing Agreements."

on the state balance sheet may be provided on a production-sharing basis in Russia. The list of sites of subsurface resources to be developed on the basis of a PSA is approved by federal law, but that law is not binding for small deposits whose reserves do not exceed the quantities specified in the PSA law.

A PSA is concluded on the basis of a competitive tender or auction, but not later than a year after the day on which the results of the tender are announced. In some cases, in accordance with a joint decision of the government of the Russian Federation and the executive body of the relevant constituent entity of the Russian Federation, and subject to certain conditions being met, a PSA may be concluded without holding a competitive tender or auction.

The Procedure for the Reimbursement of Expenditures under a PSA. One of the important aspects of the implementation of a PSA is the mechanism by which expenditures incurred by investors and operators under the agreement are classified as reimbursable and non-reimbursable.

At present, the procedure for reimbursing expenditures under a PSA out of compensatory production is determined by a decree of the Russian government. Reimbursable expenditures are "justified" expenditures of an investor or operator under an agreement, which they have incurred in the course of work under the PSA.

Reimbursable expenditures are approved by the PSA managing committee in accordance with work programmes and the agreement itself. Expenditures are reimbursed out of compensatory production received by the investor under the terms of the PSA. Reimbursable expenditures include the following:

- Expenditures on preparing and holding negotiations and on the submission for approval and expert examination of the agreement, including expenditures on the preparation of a feasibility study at the stage preceding the conclusion of the agreement; expenditures on exploratory, appraisal, and prospecting work; other expenditures incurred by the investor prior to the entry into force of the agreement.
- Expenditures by the investor on compensating the state for expenditures on exploratory and prospecting work, geological and economic appraisal, and other studies required to prepare the site for transfer of use to the investor.
- Expenditures on the exploration, appraisal, and prospecting of a deposit of mineral raw materials, including expenditures to compensate legal entities for expenditures on the site of subsurface resources in question which were incurred by them out of their own resources.
- Expenditures on the development and fitting-out of a deposit of mineral raw materials.
- Capital expenditures and operating expenditures on the extraction, storage, and transportation of mineral raw materials to a point of delivery or point of division specified in the agreement.
- Other expenditures not mentioned in this section, if they are provided for by the PSA, with the exception of expenditures not reimbursable out of compensatory production.

Non-reimbursable expenditures include the following:

- Expenditures for the acquisition of the package of geological and geophysical information for participation in the competitive tender (auction).
- Expenditures on the fee for participation in the competitive tender (auction) for the right to use a site of subsurface resources on a production-sharing basis and other expenditures incurred by the investor prior to the announcement of the winner of the competitive tender (auction).
- One-time payments (bonuses).
- Regular payments for the use of subsurface resources.
- Profits tax.
- Taxes, levies, and other compulsory payments actually paid to the budgets of constituent entities of the Russian Federation and local budgets.
- Expenditures associated with the sale of compensatory production and the portion of profit production belonging to the investor.
- Expenditures associated with the inspection (auditing) of the investor's financial and economic activities carried out at the request of the investor's shareholders (participants).
- Expenditures for financing research and development work of a general nature.

Abandonment Fund under a PSA. An essential part of the implementation of PSA projects is the performance of work associated with the temporary shutdown and abandonment of wells, the dismantling of equipment and other facilities,

and the redevelopment of the area used. This work is financed by creating an abandonment fund under the authorised federal executive body charged with exercising the rights and obligations of the Russian Federation under PSAs. Special considerations relating to the creation of an abandonment fund by an investor must be stipulated separately in each agreement.

An abandonment fund is formed from allocations made by the investor beginning on the date when commercial extraction commences or on another date specified in the agreement and from interest accruing on the balance of resources in that fund, which are kept in an account for resources placed at the temporary disposal of budgetary organisations.

An investor's expenditures connected with the creation of a liquidation fund are reimbursable in the form of a portion of extracted production in accordance with the procedure established by the PSA.

Taxation Under a PSA. The PSA law exempts an investor from all federal taxes other than the following:

- Payments for the use of subsurface resources.
- Profits tax according to the procedure established by the legislation of the Russian Federation (taking into account the special provisions of the PSA law).
- Tax on the extraction of commercial minerals.
- VAT on sales of extracted production.
- Unified social tax.
- Regional and local taxes and levies established in accordance with Russian legislation.

Payments for the Use of Subsurface Resources. The PSA law envisages three types of payment for the use of subsurface resources, the amount of which is to be established in each individual agreement:

1) One-time payments (bonuses) upon the conclusion of an agreement and/or the achievement of a specified result.

2) Annual payments for the performance of exploratory and prospecting work (rentals), established per unit of area of the site of subsurface resources used.

3) Regular payments (royalties), established as a percentage of the volume of extraction of mineral raw materials or the value of extracted production.

In the case of agreements concluded before the entry into force of the federal law "Concerning Production Sharing Agreements," the conditions established in the PSAs apply, taking into account the norms of Russian tax and levy legislation in force on the date when the agreements were signed.

Profits Tax. The PSA law sets out a number of special considerations relating to the calculation and payment of profits tax in comparison with the standard procedure, which should create a very favourable tax regime for the investor.

Taxable profit under a PSA is calculated as the value of the portion of profit production that belongs to investors under the terms of the specific agreement at market price. The value is reduced by the amount of investors' payments for the use of borrowed resources, one-time payments for the use of subsurface resources, and other expenditures not reimbursable to investors under the terms of the PSA. The composition of those expenditures and the procedure for taking them into account when determining taxable profit under PSAs are established by the legislation of the Russian Federation.

Profits tax payable under PSAs is currently levied in accordance with the law "Concerning Tax on the Profits of Enterprises and Organisations"[1].

An investor may pay profits tax in kind or in monetary form. The rate of profits tax current on the date when the PSA is signed will apply for the entire term of the relevant agreement. As we see it, however, this clause cuts both ways. With a fixed rate of tax, the investor would benefit if the standard tax rate were to rise but would be at a disadvantage if that rate were to be cut. It should be noted that activities under a PSA have to be kept "separate." For example, an investor is not entitled to reduce profit earned from the performance of the PSA by the amount of losses incurred in connection with other types of activity carried out by the investor.

Tax on the Extraction of Commercial Minerals. Investors under a PSA must determine the amount of tax on the extraction of commercial minerals which is payable to the budget. The tax base is the value of extracted commercial minerals determined in accordance with the Tax Code and special provisions of the PSA with respect to determining the value of extracted commercial minerals.

With respect to PSAs concluded in accordance with the legislation of the Russian Federation, tax rates are applied with a decreasing coefficient of 0.5.

The tax rates established in a PSA do not change during the entire term of that agreement.

In the case of agreements concluded after the entry into force of the federal law "Concerning Production Sharing Agreements" and before the entry into force of Chapter 26 of the Tax Code of the Russian Federation, the conditions for the calculation and payment of tax established in PSAs apply, taking into account the norms of Russian tax and levy legislation in force on the date when the agreement was signed.

VAT. According to the provisions of Article 178 of the Tax Code, goods, work, and services intended in accordance with planning documentation for the performance of work under a PSA (including those im-

[1] Law No. 2116-1 of December 27, 1991 "Concerning Tax on the Profits of Enterprises and Organisations" (as subsequently amended)

ported into the customs territory of the Russian Federation by the investor or operator of such an agreement, by their suppliers, contractors, and carriers, and by other persons participating in work under the agreement on the basis of agreements (contracts) with the investor and/or operator), and services rendered within the territory of the Russian Federation by foreign legal entities to investors or operators of PSAs in connection with the performance of work under those agreements, are exempt from VAT.

Turnover between the investor and the operator of a PSA involving the transfer, without consideration, of goods, materials, and funds required for the performance of work under that agreement is exempt from VAT.

In order for this exemption to be applied, the taxpayer must submit an application for exemption to the tax authorities as well as a number of supporting documents.

In the case of PSAs concluded prior to the entry into force of the federal law "Concerning Production Sharing Agreements," the conditions for calculation and payment of tax established by those agreements apply.

The standard taxation procedure applies for the sale of extracted production.

Excise Duty. The sale by investors or operators of excisable types of mineral raw materials extracted in the process of fulfilling PSAs and of products processed from those mineral raw materials, where such processing is provided for by the agreements, is exempt from excise duty if such mineral raw materials and goods are the property of the investors.

Goods imported into the territory of the Russian Federation in accordance with planning documentation (estimates) for the performance of work under PSAs are also exempt from excise duty. This exemption applies to investors, operators, and suppliers participating in work under PSAs on the basis of agreements with investors. An exemption from excise duty is allowed upon submission to tax and customs authorities of documents verifying that the excisable goods are intended for the performance of work under the PSA.

In the case of PSAs concluded prior to the entry into force of the federal law "Concerning Production Sharing Agreements," the conditions and procedures for the calculation and payment of excise duty established by these agreements apply.

Customs Duties. Investors are exempt from export customs duty in connection with the exportation from the customs territory of the Russian Federation of oil that is the investors' property under the terms of a PSA. The law of the Russian Federation "Concerning the Customs Tariff" and the Customs Code of the Russian Federation provide for goods imported into or exported from the customs territory of the Russian Federation by investors for the performance of work under a PSA in accordance with the terms of the PSA to be exempted from import and export customs duties.

Payroll Contributions. This is a field in which the PSA law does not give investors any substantial privileges on the basis of equality with other employers.

Regional and Local Taxes and Levies. The PSA law does not directly exempt investors from regional and local taxes. However, the law does stipulate that where regional and local authorities do not allow an investor an exemption from regional and local taxes, the investor has the right to increase its share of extracted production at the expense of the state's share of extracted production by the amount of such taxes, thereby effectively obtaining compensation for the amount of regional and local taxes paid. Furthermore, interest based on the refinancing rate of the Central Bank of the Russian Federation is payable from the budget on the amount of the budget's indebtedness to the investor during the period of time needed by the investor to recover such taxes.

Current Changes in PSA Legislation. At the present time, there is no unified legislative base with respect to PSAs. Currently under active discussion is a draft of Part 2 of Chapter 24 of the Tax Code ("The System of Taxation in Connection with the Fulfilment of Production Sharing Agreements"), which, according to preliminary information, envisages the replacement of all existing normative provisions on PSAs with a unified system of PSA taxation. In the framework of Part 2 of Chapter 24 of the Tax Code, it is planned to establish an exhaustive list of taxes payable under the PSA regime and to replace the mechanism for reimbursing VAT paid to the budget in connection with work performed under a PSA with a general PSA regime for all participants in PSAs. As regards profits tax, the changes introduce a specification of types of investor income unrelated to PSAs and types of non-taxable income, as well as a specification of types of expenses for purposes of calculating profits tax. It should be noted, moreover, that the draft of Part 2 of Chapter 24 of the Tax Code establishes that, in contrast to the current procedure, Russian and foreign physical persons will not be able to act as investors under a PSA.

Although the draft of the new Tax Code chapter concerning PSAs is designed to regulate the taxation of this regime and make it more attractive to investors, it is conceivable that the new conditions for the development of deposits will prove less effective and amenable than development under the traditional licensed regime. However, despite both positive and negative assessments of the prospects of PSAs, a definitive answer cannot yet be given as to whether PSAs have a future in Russia, since this depends entirely on whether fundamental changes are made to legislation and whether a consensus is reached between the demands of investors and the position of the Russian government. Chapter 24 of the Tax Code ("The System of Taxation in Connection with the Fulfilment of Production Sharing Agreements") is to be adopted in mid-2003. □