

Taxation of Subsurface Users in Kazakhstan – the Current Regime

Gerard Anderson, Olga Pivovarova (Ernst & Young Kazakhstan)

This section describes the tax regime in force as of February of 2004. Recent amendments to the Tax Code that came in effect on the January 1 2004 considerably changed subsurface users' taxation regimes. We discuss these amendments in further detail below. It is vital to realize that there are many uncertainties in the legislation as it now stands. While the general outline, as set out below is clear, the new legislation would, if applied literally, create a number of simultaneous equations that might not be possible to solve. There also are a number of key points where it is necessary to assume what costs or incomes are included in particular calculations, or how the methodology is intended to be applied. We do not identify these issues specifically in the following text, due to lack of space. We would therefore emphasize the importance of seeking advice before attempting to model this regime.

Subsurface Use Legislation

"Subsurface user" is the term used in Kazakh legislation to describe a company that is engaged in the exploration and extraction of natural resources, including oil, gas, precious metals, precious minerals, underground water, and common minerals. In certain aspects the provisions of the subsurface use and tax legislation may be different for companies extracting "commonly occurring useful minerals" – minerals such as sand, clay rubble, etc., which are used in their natural condition or after insignificant processing to satisfy local business needs. Subsurface users must all conclude individual contracts with the government of the Republic of Kazakhstan. There are two types of contracts, a PSA, referred to in the tax legislation as a Model 2 tax regime (this type of contract exempts a subsurface user from certain taxes), and a contract that envisages the payment by a subsurface user of all taxes and other obligatory payments that would generally apply to a taxpayer, generally referred to as an Excess Profit Tax (EPT) model or a Model 1 tax regime. We will use both terms throughout the text interchangeably.

From a tax perspective, PSAs differ from regular subsurface use contracts in that under PSAs, the government, without investment, receives a direct share of the field's production, in cash or in kind. The costs of the subsurface user are recovered from production in priority (subject to limitations) to the state's share. This means that the subsurface user, at his own risk, is expected to pay all initial exploration and development costs for the contract area and subsequently to recover the costs of carrying the government's interest in the contract area from the total production. Note that, technically, the state's share is a tax.

Three major laws, in Kazakhstan govern the economic terms established in a subsurface use contract. They are the Subsurface Use Law the Petroleum Law and the Tax Code. Currently the government of Kazakhstan is preparing a draft "Law on Production Sharing Agreements" in order to create a unified legislative foundation for the Model 2 regime. It is expected that this law will provide for a mandatory 50 percent participation by the state oil company.

Negotiation of Subsurface Use Contracts

A contract for subsurface use will be negotiated between a party or parties wishing to explore for and produce hydrocarbons or minerals and the appropriate arm of the government – currently the Ministry of Energy and Mineral Resources. A number of governmental bodies, including the Ministry of Finance and the Ministry of Environmental Protection, will have their input before the contract can be signed. In the past, the subsurface user was required to obtain a subsurface use license prior to negotiations of the subsurface use contract. Amendments to the Subsurface Use Law, introduced in August 1999, eliminated this requirement (the subsurface use contract, once negotiated, establishes the right to explore for and to produce petroleum or minerals).

The subsurface user and the government can opt to negotiate either a Model 1 contract or a PSA contract. A Model 1 contract will include all taxes and levies including in particular those listed in the summary below. A PSA contract, on the other hand, envisions the subsurface user taking the government as a free-riding co-venturer in the contract area as discussed above. According to the Tax Code, a tax regime applicable to a PSA contract will not include the following taxes that are applicable to an EPT contract:

- ! Economic rent tax on oil for export.
- ! Excise tax on crude oil and other mineral resources.
- ! Excess profit tax.
- ! Land tax.
- ! Property tax.

In accordance with recent amendments to the Tax Code, the procedure for calculating the government's share and a subsurface user's share in profit production is unified for all PSAs concluded after January 1, 2004.

Kazakhstan's share of the profit oil or minerals produced under a PSA contract may vary depending on how the contract is negotiated, the degree of risk, and the expected costs. We outline the procedure for calculating of the republic's share of the in later sections. An overarching principle of production sharing has been introduced into the Tax Code. The republic's share cannot be lower than 20 percent prior to payback on the project and 60 percent in the periods thereafter. In addition, the share of production devoted to the recovery of costs (cost recovery production) cannot exceed 75 percent prior to payback and 50 percent thereafter,

Starting from January 1, 2004 only PSA contracts to be signed between negotiating parties must undergo an obligatory tax expert evaluation (discussed in the following section, "Stability of the Tax Regime"), This provision also applies to amendments and additions to existing contracts. The tax regime agreed upon as the result of a tax review must be included in the final text of the contract.

Stability of the Tax Regime

Tax regimes established as a result of tax reviews are fixed in subsurface use contracts and should be consistent with the tax legislation effective on the date when the contracts are signed (concluded). Where there are changes to the tax legislation, following review of the contracts but before

their signing, the relevant tax regimes shall be subject to an additional tax review to incorporate the changes before any contracts are signed.

According to the amendments to the Tax Code that came into effect on January 1, 2004, new EPT contracts will no longer be stabilized from changes to Kazakhstan legislation, i.e., taxes and other obligatory payments will be calculated and remitted to the budget in accordance with the tax legislation in effect on the date the relevant tax liabilities arise. Nevertheless, both PSA and EPT contracts entered into before, presumably, January 1, 2004, will be grandfathered (though the drafting of the law is not entirely consistent). The amended Tax Code states that for subsurface use contracts between the government or competent authority of Kazakhstan and a subsurface user the tax regime will be maintained and kept valid for the entire period established for the contract's validity, provided the contracts have duly passed the mandatory tax review. However, one of the major concerns, whether contracts concluded prior to 1996 (i.e., prior to introduction of mandatory review clause) will be grandfathered, remains outstanding.

Additional provisions concerning stability of subsurface use contracts are contained in Article 285.1 of the Tax Code, which reads as follows:

- ! Where changes to tax legislation occur, the taxation conditions established in PSA contracts may be amended upon mutual agreement of the parties.
- ! Where changes to tax legislation result in benefits to subsurface users, the taxation conditions established in PSA contracts shall be amended in order to restore the original economic interests of the Republic of Kazakhstan.

At present, the general view is that the first paragraph of the above article constitutes the main rule – i.e., that renegotiation of the taxation conditions of a given PSA contract will only take place with the voluntary consent of both parties, and that the second paragraph is a simple statement of the desired aim of the voluntary re-negotiation. If the two paragraphs are taken as having equal force, the position is less clear, at least with respect to changes in tax legislation taking place, apparently, to the advantage of the taxpayer. Additional provision related to the stability of PSA contracts is contained in Article 285.2, which reads as follows:

"In case certain taxes and other obligatory payments to the budget envisaged by a PSA contract are annulled, subsurface users shall continue to remit these taxes and obligatory payments to the budget until the relevant changes are introduced into the contract".

This provision suggests that if the Republic of Kazakhstan repeals any tax or levy envisaged in the PSA contract, the subsurface user shall continue to pay the said tax or levy until such time as the tax provisions of the PSA contract are renegotiated. It would also be logical to infer from this that the correct reading of Article 285.1 above is that changes in tax law, favoring the taxpayer shall not automatically result in the renegotiation of the PSA contract, i.e., the consent of both parties is necessary.

Overall, the issue of the stability of tax regimes is more or less satisfactory, though the position is not as clear as it might be, because the issue is dealt within several different provisions that are not entirely consistent with each other. Accordingly, stability remains a key issue and one to which subsurface users must pay close attention.

Ring-Fencing

Sometimes, several taxpayers may carry out subsurface operations under one Model 2 contract. In this case, the tax regime established in the contract should apply equally to all taxpayers participating in such operations. For this reason, all such taxpayers are required to maintain consolidated accounts for some fiscal purposes for activities carried out under one Model 2 contract and pay taxes in accordance with this contract. However, if the arrangements are correctly structured, this does not necessarily preclude individual liability, e.g., for corporate income tax, which may be important for double taxation relief. This principle is reinforced by provisions in the current draft of the PSA law.

In addition, subsurface users operating under more than one subsurface use contract or having activities outside the scope of subsurface use contracts are required to maintain separate records of their tax liabilities with respect to each subsurface use contract or activities outside the scope of any contract. Consolidation of such income and expenses is prohibited. This means that a subsurface user may not deduct costs incurred under one contract from revenues earned in respect of another (note that the ring fence applies to the contract, not to individual geological

structures within a contract area). The above provision does not apply to contracts for extraction of common mineral resources.

legislation Governing the establishment of Tax Terms in a Subsurface Use Contract The Tax Code provides that only the Tax Code may establish provisions concerning the payment of taxes and levies relating to subsurface operations in the Republic of Kazakhstan. Separate agreements with the government may not do so.

General Structure of a Subsurface Use Contract The usual provisions contained in a contract for subsurface use are as follows:

- ! Preamble.
- ! Definitions.
- ! Purpose of the contract.
- ! Validity term of the contract.
- ! Contracted territory.
- ! Title of ownership to property and information.
- ! The right of the state to acquisition and requisition of mineral resources.
- ! General rights and obligations of the parties.
- ! Work program.
- ! Exploration period.
- ! Commercial discovery.
- ! Extraction period.
- ! Accounting reporting.
- ! Measurements (type of mineral resource).
- ! Performance of sub-contractual works.
- ! Funding.
- ! Taxes and payments accounting procedures Insurance.
- ! Liquidation and liquidation fund Protection of the subsurface and environment.
- ! Safety of the population and personnel Parties' liabilities for violation of Contract provisions.
- ! Force majeure.
- ! Confidentiality.
- ! Transfer of rights and obligations.
- ! Applicable law.
- ! Procedure for resolving disputes.
- ! Guaranties for termination and suspension of the contract.
- ! Language of the contract.

The above structure generally applies to ETP contracts.

A contract for subsurface use will establish all taxes applicable to the subsurface user over the term of the contract, either directly or by way of reference to the Tax Code in effect on the date of signing of the contract.

Specific Terms of Production Sharing Agreements

The Tax Code specifically provides for the following provisions that must be included in a PSA:

- 1) Determination of the volume and monetary value of total production.
- 2) Determination of the percentage of total production to be used for cost recovery, i.e., to reimburse the costs incurred by the subsurface user (cost recovery production).
- 3) Determination of the share of total production to be shared between the subsurface user and the Republic of Kazakhstan (profit production).
- 4) The shares (percentages) of the share of the Republic of Kazakhstan and the subsurface user's share in profit production.
- 5) Procedure for determining the share of the Republic of Kazakhstan in profit production in accordance with the Tax Code.

The tax period for payment of the share of the republic of Kazakhstan in profit production under production sharing is set as a calendar month. The republic's share must be paid no later than fifteenth of the month following the tax period. The declaration of the republic's share of profit production should be submitted to the tax authorities by the tenth of the month following the reporting month.

The Tax Code provides for a list of expenses that are recoverable under a PSA. Recoverable expenses are defined as justified expenses of a subsurface user actually borne during the execution of the work program. There is no definition for the term "justified," but clearly issues such as whether the expense is part of an approved work program and is supported by proper documentation are important. The share of production allocated to cost recovery may not exceed 75 percent prior to payback and 50 percent post-payback.

Recoverable Expenses Include:

- 1) Expenses actually borne by the subsurface user prior to signing the contract:
 - ! Expenses for preparation and development of the project's feasibility study during the stage preceding the conclusion of the contract
 - ! Expenses for prospecting, appraisal, and exploration works related to the project and performed before the contract comes into force.
- 2) Expenses actually borne by the subsurface user from the date when the contract comes into force and during the period of its validity.

Administrative expenses relating to the execution of a contract, which include rental expenses for offices of the subsurface user, including offices outside the territory of the Republic of Kazakhstan; expenses for their maintenance, information and consultation services; representative expenses; advertising expenses; and other administrative expenses under the conditions of a contract, shall be refunded according to the standard established by the contract and are deductible within 1 percent of the total amount of recoverable expenses of the subsurface user in a reporting period.

Non-Recoverable Expenses Include:

- ! Expenses for the payment of a fee for participation in tenders for subsurface use rights.
- ! Expenses for the purchase of geological information.
- ! Expenses in excess of the limits established by the contract, including those related to administrative expenses.
- ! Expenses for paying the fee for pollution of the environment exceeding established limits.
- ! Expenses related in the sale of the cost production and part of profit production owned by the subsurface user, including expenses for the transportation of this production from the point at which the subsurface user received ownership to the sale point, losses during transportation, transportation insurance expenses to the sale point, commission fees and other expenses.
- ! Expenses related to the audit of the activities, performed at the request of owners.
- ! Expenses incurred as a result of failures in performance by the subsurface user of the responsibilities stipulated in the contract (including expenses arising from the breach by a subsurface user of its contractual obligations with respect to local content requirements).

- ! Expenses related to excursions and traveling.
- ! Expenses for payments of interest on loans and for use of borrowed funds; losses incurred due to accidents caused by a subsurface user resulting from failure to observe technology and safety measures.
- ! Expenses for social projects.
- ! Expenses for the voluntary insurance of employees.
- ! Costs incurred in connection with legal proceedings.
- ! Fines and interest penalties imposed by any state bodies on a subsurface user.
- ! Costs relating to the payment of expenses to be used for the personal needs of employees, which are not stipulated by legislation of the Republic of Kazakhstan.
- ! Bonuses.
- ! Taxes and obligatory payments paid to the budget.
- ! Remaining non-refundable costs without the accrual of interest (uplift), which are carried forward to the following tax period.
- ! Other expenses not related to the activity under the contract.

Recoverable EXPENSES of the Subsurface User Are Reduced By:

- ! The amount of operating income related to receipt of rent payments for rental of property treated or acquired under the contract, after deduction of related expenses.
- ! The amount of other income (penalties, interest, etc.) received from the activity under the contract.

Taxes Applicable to Subsurface Users

The taxes and levies listed below will normally apply to the activities of a subsurface user under EPT contracts only, except for bonuses and royalties, which apply to subsurface users operating under a PSA contract as well. The republic's share is only applicable to a PSA contract.

As was previously discussed, a Model 1 contract envisages paying all taxes and levies including those established below, while a Model 2 contract is a PSA.

It can be inferred that the tax burden stemming from the PSA type tax regime may be greater. In reality, the payment burden will differ if the economics of a project are more – or less – favorable

than what was originally anticipated when the project was negotiated.

Bonuses

General Provisions Concerning Bonuses

Bonuses are fixed payments of subsurface users. The subsurface users are expected to pay two types of bonuses:

- 1) Subscription bonus
- 2) Commercial discovery bonus

In the past, many contracts established production bonuses that were payable when certain production levels were reached. These are no longer included in contracts negotiated after July 1, 1998. as the production bonuses are essentially no different than royalties, and were deleted by legislative changes.

Subscription Bonus

The subscription bonus is a single fixed payment by a subsurface user for the right to carry out subsurface use.

The initial amount of the subscription bonus is defined by the government of the Republic of Kazakhstan based on the volume of mineral resources and economic value of the field. The final amount of a subscription bonus is established by a commission at the conclusion of a tender held to award the right to use the subsurface. It is included in the contract, taking into account the economic value of the fields (contract territories) covered by the contract, but it cannot be lower than the initial amount set by the government.

The subscription bonus should be paid no later than 10 days from the date when the contract comes into force.

Commercial Discovery Bonus The commercial discovery bonus is a fixed payment that is paid by subsurface users when a commercial discovery is made on the contract territory.

Under contracts for the exploration of fields of mineral resources that do not envisage subsequent production of those minerals, the commercial discovery bonus is not paid. The base for calculating the commercial discovery bonus is defined as the value of the extractable minerals duly approved by the competent state authorities. The value of the mineral resources is determined using the market price established at the International (London) Exchange for the given mineral resource on the day the bonus payment is made

When a market price for a mineral resource has not been established the value of extracted minerals is determined based on the planned costs of extraction adjusted by the planned profitability as indicated in the work program approved by the competent authority. From January 1, 2004 the rate of commercial discovery bonus is fixed at 0.1 percent of the value of proven extractable resources. Previously, the rate of commercial discovery bonus was not fixed, i.e., it could vary depending on the specific conditions of subsurface use operations but could not be lower than 0.1 percent.

Royalties

A separate royalty regime applies to each type of mineral resource produced in the contract area (i.e., in a field producing both natural gas and oil, each may have a different royalty rate). Royalties are normally paid in cash unless the Kazakhstan government establishes payment in kind. If payment is to be in kind, the mechanism should be set out in an additional agreement with the competent authority. Cash royalty payments will usually be calculated by multiplying the production by a netted back price.

Royalties are calculated on the value of the produced mineral resources. For hydrocarbons this value is calculated on the basis of the average selling price in the reporting period, exclusive of indirect taxes, and reduced by the actual transportation expenses to the place of sale (shipment).

Volume of accumulated oil production for each calendar year (thousand tons)	Royalty rate
Up to 2,000	2%
From 2,000 to 3,000	3%
From 3,000 to 4,000	4%
From 4,000 to 5,000	5%
More than 5,000	6%

Recent amendments to the Tax Code introduced a sliding scale of royalty rates for oil and associated gas. The royalty rate depends on volume of accumulated oil production for each calendar year.

The treatment of a pure gas field is not clear.

For purposes of calculating royalty, associated gas hydrocarbons should be converted to their crude oil equivalent at the ratio of 1,000 cubic meters to 0.857 ton of crude oil. Moreover, the above-mentioned amendments introduced rules on how gas hydrocarbons are valued in the case of free-of-charge transfer for further processing. The value will be based on actual costs of production and

primary processing, increased by the actual rate of return for the tax period.

Royalties must be paid by the fifteenth day of the month following the reporting period, which may be a calendar month or a quarter, depending on the volume of royalty payments to the budget.

Economic Rent Tax on Oil for Export

A new tax was introduced into the Tax Code, and is effective from January 1, 2004. The payers of this tax are legal entities and individuals exporting crude oil for sale. This tax applies to all types of enterprises/ individuals exporting crude oil for sale; it is not limited to subsurface users, although PSA contract holders are exempt from it in respect of production from their own contract areas. The taxbase is determined as the value of the exported crude oil (based on the market price), netted back for transportation costs and for quality of oil. Market price is defined as the weighted average of daily sales prices prevailing on the market for identical crude oil brands in international trade. The crude oil brands basket is established by the government, and the daily average market rate for each crude oil brand is calculated as a simple average of oil exchange opening and closing prices for the brand. The tax rates applied to the netted back market price depend on current oil prices and vary as follows:

Oil market price at the level of oil exchange price (USD/barrel)	Rate of economic rent tax on oil for export	Oil market price at the level of oil exchange price (USD/barrel)	Rate of economic rent tax on oil for export
19	1%	29	22%
20	4%	30	23%
21	7%	31	25%
22	10%	32-33	26%
23	12%	34-35	28%
24	14%	36	29%
25	16%	37	30%
26	17%	38-39	31%
27	19%	More than 40	33%
28	21%		

The tax period of economic rent tax on oil for export is a calendar month, and the deadline for submission of the tax declaration is the tenth day of the month following the reporting month. The tax is payable by fifteenth day of the month following the reporting month.

Excess Profit Tax

Subsurface users operating under a Model 1 contract are subject to excess profit tax in accordance with the procedure and at the rates established below.

The procedure for calculation of excess profit tax changed significantly starting January 1, 2004. Prior to that date, it was a conventional IRR-based calculation. Under the new regime, the tax base is the net income of a subsurface user in excess of 20 percent of tax deductions. The tax base can be adjusted for the expenditures actually incurred for education of the Kazakh work force and/or increase of fixed assets, but not exceeding 10 percent of the taxable amount. The tax rates are established on a sliding scale ranging from 15 per cent to 60 percent and depend on net income and deductions of a subsurface user. Excess profit tax is paid separately with respect to each subsurface use contract.

Excess profit tax is calculated by multiplying the tax base by the rates established below:

Amount exceeding 20% of the ratio of net income to deductions	Excess profit tax rate
Up to 5%	15%
From 5 % to 15%	30%
From 15% to 30 %	45%
More than 30%	60%

It is easier to demonstrate this calculation with numbers than words.

Description	Amount	
	Example #1	Example #2
Assume:		
Sales income	100	100
Deductible Costs	70	30
Taxable Income	30	70
CIT	9	21
Net income	21	49
<i>Then:</i>		
20% of deductions	14	6
TAX base (excess of net income over 20%) of deductions	7	43
Ratio of net income to deductions	30%	163%
Amount of exceeding there of exceeding 20%	10%	143%
ETP rate	30%	60%
ETP amount	21	25,8

Kazakhstan's share in Profit Production

One of the major developments introduced by the recent amendments to the Tax Code was the specification of a comprehensive subsurface user's share calculation for all new (i.e., concluded after January 1, 2004) PSA contracts, effectively eliminating any flexibility. The share of the subsurface user in profit production is determined as the lowest of three percentage values given by the following three triggers:

- 1) *R*-factor (profitability index) – the ratio of subsurface user's accumulated income to accumulated expenditure under the project.
- 2) Internal rate of return (IRR) of contractor – discount rate when net real discounted income (presumably net present value) reaches its zero value.
- 3) *P*-factor (price factor) – ratio of subsurface user's income to the total production volume during the reporting period.
- 4) It will be seen from the tables below that the triggers move quite rapidly from maximum inventor take to minimum take.

An important change to the valuation of subsurface users profit production is introduced. The valuation will be based on the price used for economic rent tax purposes, i. e., the market price netted back for transportation costs and quality banking (as discussed above).

A key provision is the requirement that the state's total tax take, including taxes such as corporate income tax and share in profit production, should exceed targets that are hard coded in the legislation. The minimum limit will be applied for each month, so that the state will, in one form or another, receive not less than 20 percent of the total monthly value of production prior to payback and 60 per cent after the payback, giving rise to a "top up" tax. This appears to be an absolute tax charge, and not an advance payment of future state shares. Payback itself is not clearly defined, but is assumed to mean when cost oil exceeds costs, so that the cost recovery account reaches a zero balance.

An additional ceiling on the split of profit production will apply when "conditions of a production-sharing contract realization deteriorate," which is a rather ambiguous statement. In this event, the republic's share of profit production would not be lower than "its maximum amount fixed prior to the deterioration unless such maximum amount

was reached due to the P-factor trigger when calculating the profit production of a subsurface user.” The interaction of all of these ceilings appears complex, but at first sight it would seem likely that the key limits will be the guarantee that the government receives 20 percent of pre payback value and 60 percent post payback; most of the other calculations may be of little relevance.

R- Factor

The R-factor is the ratio of accumulated income to accumulated expenditure under the project. Income accumulated under the project is calculated as:

! Real (i.e., deflated) aggregate value of the subsurface user’s cost recovery production;

plus Real aggregate value of the subsurface user’s profit production:

less Real aggregate income tax paid to the budget.

Expenditure accumulated under the project includes only recoverable costs and is calculated as:

! Real aggregate recoverable operating costs;

plus Real aggregate recoverable exploration and appraisal costs;

plus Other real aggregate recoverable costs of subsurface user.

Both income and expenditure will be determined on an accruals basis. Based on the R-factor calculated as above, the share of the subsurface user is determined as follows:

R-factor	Subsurface user’s share of profit production (%)
Less or equal to 1.2	70%
More than 1.2 less than 1.5	70%-2.068* (R-factor – 1.2)*100%
More or equal to 1.5	10%

IRR

IRR is the annual discount rate, at which the net present value (NPV) of the project is zero. NPV is calculated based on the discounted deflated cash flows for each reporting period (a calendar month) starting from the effective date of the PSA. Potentially, this implies that pre-effective costs will not be included into the calculation. The proposed changes do not explain how IRR is to be calculated (i.e., as a monthly rather than annual amount, and how current tax liabilities are to be included)

and how monthly and annual amounts co-relate. Presumably, the annual discount rate (IRR) will be calculated via compounding as $(1 + \text{monthly discount rate})^{12} - 1$.

The deflated cash flow for a reporting period is calculated as the difference between the deflated values of cost recovery and profit production of the subsurface user and the deflated values of its costs. The costs include operating, exploration and appraisal; development costs; taxes paid within the one-month reporting period (except for the government’s share of production); commercial discovery bonus; and the part of the signature bonus related to a particular development area paid in the reporting period.

Once IRR is calculated as above, the share of the subsurface user is determined as follows:

IRR	Subsurface user’s share of profit production (%)
Less or equal to 12%	70 %
More than 12% less than 20%	70%-7.51* (IRR-12%)
More or equal to 20%	10%

P-Factor

P-factor (price factor) will be calculated as the ratio of the sum of deflated cost recovery production and subsurface user’s share of profit production for the reporting period to the volume of oil produced during the reporting period. The numerator of the ratio should be calculated without taking into account sales expenses.

Depending on the P-factor calculated as above the share of the subsurface user is determined as follows:

P-factor	Subsurface user’s share of profit production (%)
Less or equal to USD 12 per barrel	70%
More than 12 but less than USD 27 per barrel	70%-0.04* (P-factor -12)*100%
USD 27 or more per barrel	10%

The tax period is a calendar month, and the deadline for submission of a tax declaration is the tenth of the month following the reporting month. The government’s share is payable by the fifteenth day of the month following the reporting month.

Environmental Fees

For the purposes of environmental legislation, users of mineral resources are liable for payment of environmental fees, of which there are two types:

! Fees for the use of certain natural resources.

! A fee for pollution of the environment.

The taxable base and rates for the above environmental fees vary depending on the nature of the subsurface user's activities, volumes of natural resources used, volumes of pollution, etc.

Generally, the above fees are different from taxes in that they may vary not only from contract to contract but from one taxation object to another. In addition, some of the fees are subject to negotiation with and/or approval by an authorized government body. Below we briefly discuss the environmental fees that are the most relevant to a subsurface user.

Fee for the Use of a Plot of Land

The fee for the use of a plot of land is collected for the provision by the state of plots of land for the temporary onerous use of land (a lease). The procedure for the provision of plots of land for the temporary onerous use of land is established by a legislative act of the Republic of Kazakhstan.

The rates of the fee are determined in accordance with land legislation of the Republic of Kazakhstan and cannot be lower than those of land tax. The amount of the fee is calculated on the basis of agreements for the temporary onerous use of land concluded with the local executive body.

The fee is paid to the budget where the plots of land are situated.

Fee for the Use of Water Resources from Surface Sources

The fee for the use of water resources from surface sources is collected for all types of special water use from surface sources regardless of whether that use involves the drawing of water from those sources or not.

Special water use is carried out on the basis of a permit issued by the authorized body for the management of water resources. The types of water use are established by water legislation of the Republic of Kazakhstan.

The object of taxation will vary depending on the actual use of water.

The rates of the fee are established by the government of the Republic of Kazakhstan. The fee is paid to the budget at the location of the special water use as specified in the permit

The Fee for the Use of Specially Protected Nature Reserves

The fee is collected for the use of specially protected nature reserves of the Republic of Kazakhstan for scientific, cultural and educational, training, tourist, recreational, and limited economic purposes.

The rates of the fee for the use of specially protected nature reserves of national interest are established by the government of the Republic of Kazakhstan.

The rates of the fee for the use of specially protected nature reserves of local interest are established by local representative bodies at the request of local executive bodies.

The fee is paid to the budget at the location of a specially protected nature reserve by wire transfer, in cash at control admission points, or at specially equipped places established by the administration of a specially protected nature reserve, on the basis of pre-numbered accounting forms.

Fee for Pollution of the Environment

The fee for pollution of the environment is collected for activities conducted within the territory of the Republic of Kazakhstan in accordance with the procedure for special use if the natural environment as determined by legislative acts of the Republic of Kazakhstan. Special uses of the natural environment can only be carried out on the basis of a permit issued by the authorized body for the protection of the environment.

The object of taxation is the actual volume of emissions within and (or) in excess of the established limits and discharges (including accidental) of pollutants and of the disposal of production and consumption waste.

The rates of the fee are established by local representative bodies on the basis of calculations made by the authorized body for the protection of the environment.

The fee is paid to the budget at the location of the source (object) of pollution of the environment indicated in a permit, with the exception of movable sources of pollution, for which payments are made to the budget at the place of their state registration by the authorized body.

Note that for the purposes of environmental protection, the procedure of processing the documentation and obtaining a permit for special use of the natural environment is different for the following regions:

- ! Space Complex Baikonur;
- ! Caspian Sea Region;
- ! Irtys River;
- ! Ural River;
- ! Tobol Rives;
- ! Ili River;
- ! Syrdaria River.

In particular, while for all other regions the processing of the documentation prior to issuing a permit is conducted on the local level (i.e., on the level of city or oblast), for the above regions, both processing the documentation and issuing a permit is conducted by the central body responsible for protection of the environment. Please note, however, that the definition, for example, of the "Caspian Sea region" is not provided.

Other Fees

Besides environmental fees, a subsurface user may also be subject to other fees and charges, depending on the actual nature of its activities. Below are the examples of such additional fees.

The Fee for the Use of the Radio Frequency Spectrum

The fee is collected for nominal frequencies (bands, ranges) of the radio frequency spectrum. The right to use the radio frequency spectrum must be certified by documents issued by the authorized body for communications in accordance with the procedure established by the legislation of the Republic of Kazakhstan.

Nominal frequencies of the radio frequency spectrum may be allocated on a competitive basis in accordance with the legislation of the Republic of Kazakhstan. The winner of a competitive tender must make a one-off payment (similar to the subscription bonus) to the state budget in accordance with the procedure established by the legislation of the Republic of Kazakhstan.

The fee is calculated by the authorized body for communications in accordance with the technical

parameters specified in the authorization documents and on the basis of annual rates depending on the type of radio communication and the territory in which the radio frequency spectrum is used.

The fee is paid to the budget of the main tax registration of a taxpayer.

The Fee for the Use of Navigable Waterways

The fee is collected for the use of navigable waterways of the Republic of Kazakhstan. The right to use navigable waterways of the Republic of Kazakhstan is granted by a document issued by the authorized body for transportation control for each calendar year. In the absence of the appropriate authorization document, the basis for the collection and payment to the budget of the fee is the actual use of navigable waterways of the Republic of Kazakhstan.

The rates of the fee are established by the government of the Republic of Kazakhstan.

The fee is paid to the budget where use of the navigable waterways takes place.

In addition to the taxes and fees highlighted above, a number of additional fees and charges exists in the Tax Code. We list the ones that may be most relevant to subsurface users:

- ! Levy for state registration of legal entities.
- ! Levy for state registration of the right to immovable property and transactions relating to it.
- ! Levy for state registration of radio-electronic and high frequency devices.
- ! Levy for state registration of mechanical modes of transport and trailers.
- ! Levy for state registration of marine, river and small vessels.
- ! Levy for state registration of civil aircraft.
- ! Levy for passage of motor vehicles through the territory of the Republic of Kazakhstan.

Overall, in light of the government's increased attention to environmental protection, environmental fees, and non-tax payments in general, may become a significant part of the overall tax take for a subsurface user. In addition, obtaining approvals of various authorized bodies for use of certain natural resources requires significant time and involvement on behalf of a taxpayer. Therefore, when planning its activities in Kazakhstan, a subsurface user needs to pay close attention to such fees.

Project Economics

To model the economic effect of the subsurface tax regime introduced on January 1, 2004, we have created a totally hypothetical set of project data that might apply to a new Caspian offshore project, summarized as follows:

- ! Oil Price – USD 30, in 2004 money.
- ! Recoverable reserves – 3 billion barrels.
- ! Capital expenditure – USD 9 billion, real.
- ! Project life – 23 years.

The above data set was put into the model of a typical PSA negotiated in the mid-1990s in another country. The result was a real rate of return of 20 percent. The same data gave a real rate of return of 9 percent under the new PSA regime in Kazakhstan, but 15 percent under the new Kazakh EPT regime. This in turn contrasts with the 24 percent real rate of return that such a project would have earned under the previous EPT regime.

Our modeling is subject to the warning at the start of the previous section that there are many uncertainties in the details of how the calculations should be performed. We have generally taken an optimistic interpretation in calculating our results. It should also be noted that these calculations ignore the effect of any carry of the state oil company that might be required.

Considering first the economics of a PSA under the new regime, the position would be as follows:

The respective real net cash flows of the state and the investor appear is set out in graph 1.

The outstanding feature of this chart is the collapse of the investor's cash flow once the initial capital outlay has been recovered. This is because the profit oil triggers a rapid reduction in the investor's cash flow to a mere 10 percent share of profit production (gross production minus cost production and royalty), and that is subject to corporate income tax. The dip in income in year nine is due to the incidence of top up tax. The recovery in year 10 is due to the end of capital expenditure.

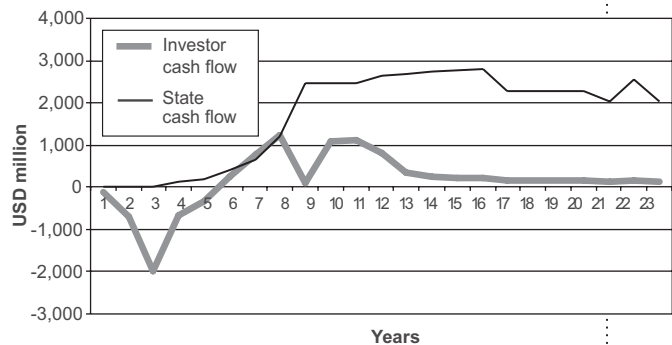
The investor's cash flow is analyzed in graph 2.

In the tenth year, cost oil reduces as the ceiling lowers from 75 percent to 50 percent upon payback. Thereafter, the investor's share of profit production is rapidly reduced by the steep slope on the dominant R-factor trigger. Note, incidentally we have assumed that the investor receives royalty oil from which to pay royalty. This is not clear from the Tax Code but is a logical inference and is worth about 4 percent on

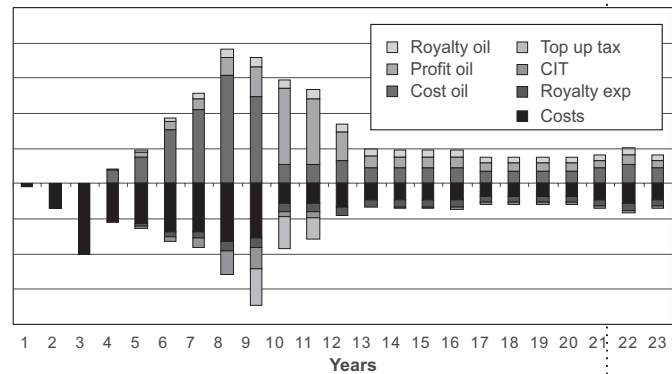
the IRR. This graph also illustrates the effect of the top up tax – the requirement that Kazakhstan receives 20 percent of gross revenues before payback, and 60 percent after payback. Hence the major effect of this tax is in years nine, ten, and eleven, when the 60 percent requirement kicks in at a time when the investor is receiving a significant amount of profit production. We have assumed this tax is an absolute cost and not a "payment on account."

The mirror of this picture is seen in graph 3, which analyzes the state's share.

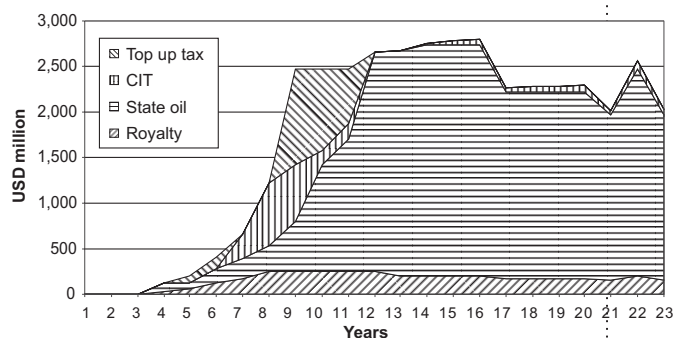
Graph 1. Cash Flows from Project



Graph 2. Investor Cash Flows



Graph 3. Analysis of Stake Take



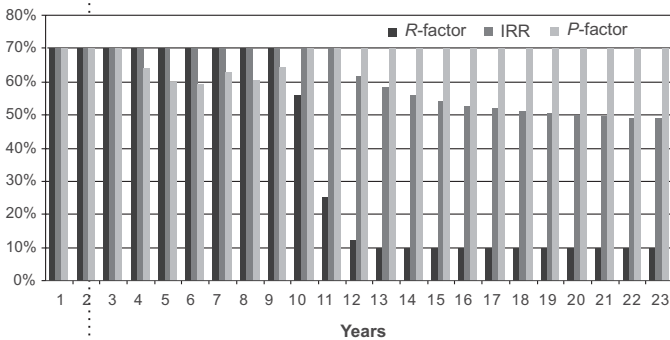
This graph clearly illustrates the dominant role of the state's share of the profit oil in dividing the project's value. This in turn is a function of the action of the triggers that divide profit oil.

The investor is allocated the lowest of the shares of profit oil determined by the three triggers R-factor, IRR and P-factor. The behavior of the triggers is set out in graph 4.

The IRR trigger would allocate over 50 percent of profit oil to the investor throughout the period.

The P-factor has the effect of significantly reducing the investor's share of profit oil in periods when the investor receives significant amounts of cost oil, years five through nine. However, the effect is muted because the total amount of profit oil pre-payback is limited. The R-factor trigger dramatically reduces the investor's share as soon as payback is achieved, and so is the most effective trigger. Note in particular how rapidly the investor is moved on this trigger's scale from a 70 percent share towards 10 percent.

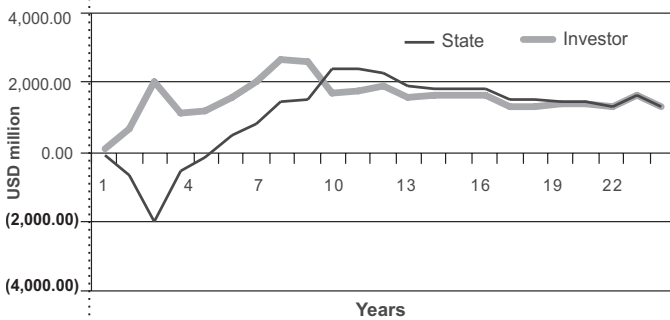
Graph 4. Triggers – Investor Share of Profit Production



It is not intended to offer in this guide a view on the acceptable rate of return for investors. That is a matter for the oil companies and the government to discuss. However, it might be expected that investors would aspire to a 20 percent rate of return, and so it is worth considering what changes might achieve this.

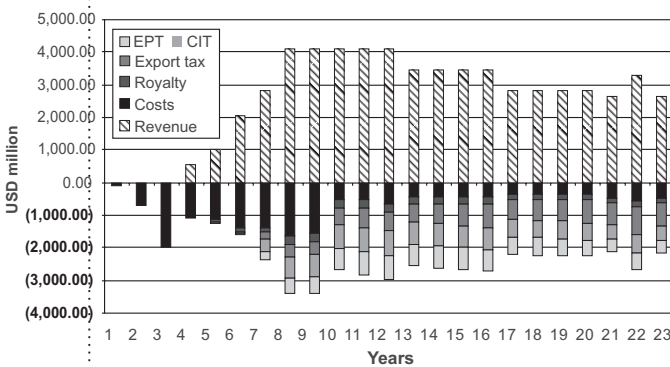
Of course PSA economics are very sensitive to the particular fact set. In this particular case, the following changes would have the following effects, though these should be regarded as no more than one isolated example.

Graph 5. Cash Flows New EPT Regime



	Real Rate of Return
Base case	9%
Remove top up tax	14%
Remove P-factor	14.5%
Change the slope on R-factor to one more typical of mid-1990s PSAs	19%
Abolish royalty	20%

Graph 6. Investor Cash Flow – New EPT Regime



As noted above, the same project would, under the new EPT regime, obtain a real rate of return of 15 percent. The cash flows of the state and the investor would be as follows (Graph 5).

The investor's cash flow would be analyzed as follows, assuming that 100 percent of production was exported (Graph 6).

Taxation of Business Profit

In addition to the taxes outlined above, the business profits of a subsurface user are taxed as follows.¹

CORPORATE INCOME TAX

The corporate income tax rate is 30 percent of taxable income. Taxable income is calculated as the difference between aggregate annual income (after certain adjustments) and statutory deductions.

¹ Please note that Ernst & Young Kazakhstan publishes a separate brochure (Kazakhstan: A Business and Investment Guide) describing taxation of business profit and indirect taxation in more detail.

Deductions

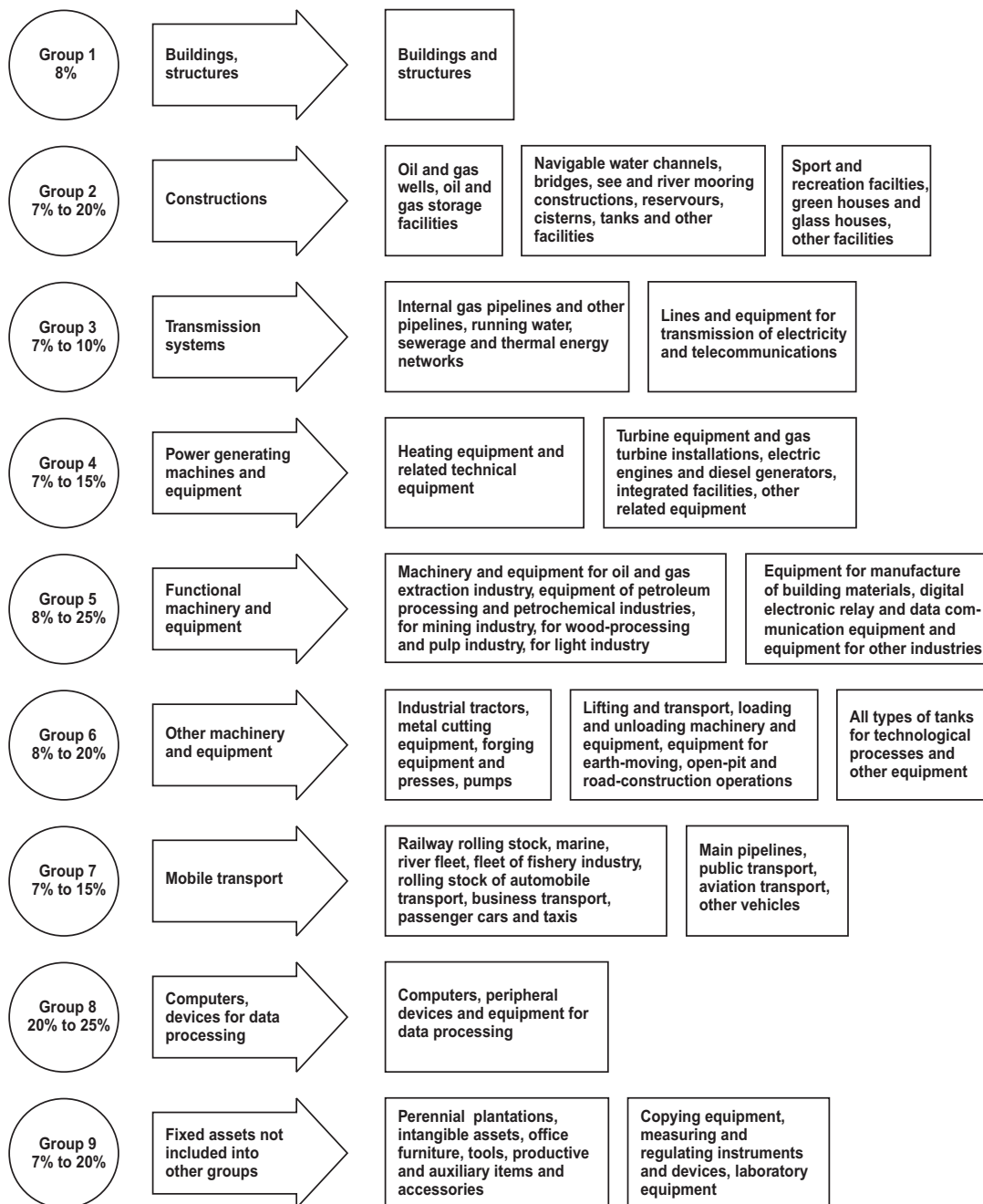
All expenses related to the generation of aggregate annual income are deductible for corporate income tax purposes. A non-exhaustive list of expenses that are allowed for deduction can be found below:

- ! Interest expense (within limits).
- ! Amounts paid to funds to provide for site restoration and clean up. The terms for site restoration are established in the subsurface use contract.

! Expenditures on geological studies, exploration and preparatory operations for extraction of mineral resources.

Geological studies, exploration and preparatory operations for production of useful minerals include the following: appraisal, preparatory work, general and administrative expenses, and costs associated with the payment of bonuses. These costs together with expenditures on intangible assets (expenditures incurred by a taxpayer while acquir-

Chart. **DEPRECIATION RATES AND CLASSIFICATION OF FIXED ASSETS**



ing the right to geological exploration, development, or extraction of mineral resources) form a separate depreciation group for tax purposes and may be deducted through depreciation at a rate not exceeding 25 percent using a declining balance basis. Similar expenses incurred after the separate depreciation group has been formed are included in the group to increase its balance value – in other words exploration and appraisal incurred after production commences on the contract area.

Revenue from pilot production is not allowed to reduce capitalized expenditures, but rather is taxed as any other revenue from sales of minerals during exploration and development.

The following expenses are also deductible:

- ! Foreign exchange losses when a foreign exchange loss exceeds a foreign exchange gain.
- ! Expenses on social payments to employees.
- ! Insurance premiums (except for insurance premiums paid according to accumulative insurance contracts, within the established limits).
- ! Amounts paid as redemption of doubtful payables previously written off as income.
- ! Doubtful receivables not redeemed within 3 years.
- ! Taxes paid (except for the taxes already excluded prior to determining aggregate annual income, income tax paid in the territory of the Republic of Kazakhstan and in any other states, and the tax on excess profit).
- ! Fines and penalties, except for those payable to the state budget.
- ! Charitable contributions to the state's social infrastructure: orphanages, handicapped organizations, and others (only a portion of the amount donated can be deducted).
- ! Expenditures actually incurred by a subsurface user with respect to training Kazakhstan personnel and the development of the social sphere of rural areas, within amounts stipulated in the subsurface use contracts.

Losses pertaining to subsurface use contracts may be carried forward for up to seven years.

Depreciation

Tax depreciation in respect of fixed assets is calculated in accordance with the rates provided below.

According to the amendments to the Tax Code that will come into effect January 1, 2005, depreciation rates for some items will be increased. In total,

depreciation rates for nine items will be increased by between 2 percent and 7 percent per item.

BRANCH PROFITS TAX

In addition to corporate income tax, the permanent establishment of a foreign legal entity is subject to a branch profits tax of 15 percent, levied on net income after corporate income tax – i.e., an aggregate tax burden of 40.5 percent of income.

Double tax treaties may reduce the amount of branch profits tax to 5 percent. However, subsurface use contracts concluded after a double tax treaty has been signed usually take into account the reduced branch profits tax rate in arriving at the estimated internal rate of return of the parties.

Indirect Taxation

Value Added Tax

Crude oil, natural gas and gas condensate sold in the territory of Kazakhstan is subject to 15 percent VAT. Export of crude oil, natural gas and gas condensate is subject to zero-rated VAT; however, export to Russia is subject to 15 percent VAT.

Under the Tax Code, international transportation services (including transportation of oil and gas via trunk pipelines) are subject to zero-rated VAT.

Imports of goods and equipment are subject to 15 percent import VAT. The government has also established a list of certain goods and equipment that may be imported pursuant to a special procedure that effectively results in no import VAT being paid (usually referred to as the offset mechanism). Some oil and gas equipment is included on this list.

In May 2002, the government issued a special resolution establishing that starting from January 2002, Russian VAT due on purchases of crude oil, natural gas and gas condensate from suppliers in Russia should be offsettable against the VAT liabilities of the purchaser in Kazakhstan provided that this VAT is indicated on invoices issued by suppliers in Russia. The amount of VAT on purchases from Russian suppliers can only be offset within the amount of the Kazakh VAT rate in effect on the date of shipment of goods. A similar ruling exists in Russia with respect to supplies from Kazakhstan.

Geological Prospective Exemption

Geological prospecting is exempt (without a credit for VAT paid) from VAT. Geological prospecting is defined as a complex of works that are interrelated, performed in a determined sequence, and providing for prospecting, exploration, appraisal

and preparation of hydrocarbon or mineral deposits for development. An exemption is applied in relation to geological prospecting and geological exploration work conducted by a taxpayer (contractor, subcontractor) within the framework:

- 1) Of a contract for subsurface use concluded in accordance with the legislation of the Republic of Kazakhstan: to conduct exploration work on subsurface plots (patented geological claim) or to conduct work relating to the joint exploration and extraction of subsurface plots (patented geological claim) during the exploration stage.
- 2) An agreement concerning state procurement of work for the geological study of the subsurface.

A list of the specific types of geological prospecting and geological exploration work, certain types of special work (which are a significant part of geological prospecting and geological exploration work), and their volume and value should be determined in the project program for each geological (scientific and geological) object. This should be based on the aims of the research and the specific details of the geological object, scientific and technical capabilities, the geological and methodological requirements for the production of geological exploration and prospecting work, the requirements for the protection of the subsurface, and the surrounding environment. It is implied that the above exemption applies to all levels of subcontractors provided that their work/services are listed in the project program. However, indication of all possible work/services in the project program in advance is very difficult.

Place of Supply Rule

The applicability of Kazakh VAT is determined based on the deemed place of supply of a given turnover. It is important to note that under the place of supply rules, a service may be physically performed outside of Kazakhstan, but deemed to be supplied inside Kazakhstan for VAT purposes (for example, the supply of a service related to immovable property located in Kazakhstan, or a consulting service performed outside of Kazakhstan for a customer inside Kazakhstan). Where the place of supply is deemed to be outside of Kazakhstan, the underlying turnover is not subject to Kazakh VAT. The rules determining the place of supply are generally as follows.

For goods:

- ! Place where transportation commences if goods are transported or mailed.
- ! Otherwise, place where goods are transferred to the purchaser (it is not clear whether this involves a physical transfer or a transfer of rights).

For works and services:

- ! Place where immovable property is located for works and services directly related to such property.
- ! Place where works and services are actually carried out for works and services related to movable property.
- ! Place of business or any other activity of the customer for the following works and services: transfer of rights to use intellectual property, consulting services, audit services, engineering services, legal services, accounting services, attorney's services, advertising services, data processing services, rent of movable property (except for rent of motor vehicles), supply of personnel, communication works and services, etc.
- ! Otherwise, the place of business or any other activity of the service provider.

Sales of goods or services that are merely auxiliary to a principal sale will be deemed to take place wherever the principal sale takes place. No definition of auxiliary sales is provided in the Tax Code.

Customs Duties

The Customs Code² provides that customs exemptions for goods imported for the own needs of subsurface users operating under subsurface use contracts concluded before the new Customs Code came into force continue to apply. In particular such goods were exempt for contracts concluded between April 1998 and the date the new Customs Code came into force. Such goods are still subject to customs clearance fees. It is not clear whether these are grandfathered (arguably, they are generally not), in which case the rates of the customs clearance fee apply as recently established by the government of the Republic of Kazakhstan: EUR 50 (USD 64.2)³ for the main page of the customs declaration and EUR 20 (USD 25.7) for each addition page.

For goods that are not imported for the needs of subsurface users operating under grandfathered subsurface use contracts, customs duties will normally apply at rates ranging from 0 percent to 30 percent. The import of most oil and gas equipment will be subject to customs duties between 5 percent and 10 percent. Equipment imported for exploration activities will often be exempt from customs duties.

Customs legislation provides for a temporary import regime that, in general, exempts goods and equipment from customs duties and import VAT in the event these goods and equipment will be re-exported.

² The Customs Code of the Republic of Kazakhstan of April 5, 2003 effective from May 1, 2003

³ The exchange rates used in this brochure are exchange rates established by the Kazakhstan Stock Exchange as of February 18, 2004.

Excise Tax on Petroleum Products or Importation

Crude oil is subject to excise tax at the moment of sale of the crude oil or at the moment of transfer of the crude oil to a processing facility. The rate of excise tax for domestically produced, as well as imported, crude oil and gas condensate is currently set at zero.

The following rates of excise tax apply to domestically produced and imported petroleum and petroleum products:

Products	Exercise tax per ton*	
	Domestically produced, in KZT	Imported, in EUR
Petrol	500-5,000 (USD 3.6 - USD 36)	31 (USD 40)
Diesel fuel	60-600 (USD 0.4 - USD 4.3)	0
Crude oil, Including gas condensate	0	0

**This table is effective as of February 1, 2004*

OTHER TAXES

Property Tax

Property tax is calculated as 1 percent of the average residual value of depreciable assets per annum, other than vehicles and land.

Land Tax

Land tax varies from KZT 0.48 (USD 0.003) to KZT 5,790 (USD 42) per hectare depending on land quality and purpose.

Vehicle Tax

Most vehicles are subject to tax according to established rates. Tax on vehicles is paid annually and computed based on monthly computation indices. The monthly computation index (MCI) currently equals KZT 919 (USD 6.6). The tax ranges from 1 MCI (USD 6.6) to 117 MCIs (USD 773) per year depending on technical characteristics of the vehicle.

Transfer Pricing

Under the Law on Transfer Pricing, starting January 2001 transfer pricing regulations apply to the following cross-border transactions:

- 1) Transactions between mutually dependent or interrelated parties.
- 2) Barter transactions.

- 3) Transactions involving offset of counter claims of a similar nature (including cession of claims).
- 4) Transactions with persons registered (residing) or having bank accounts in foreign countries, the legislation of which does not require disclosing and submitting information when conducting financial transactions, or in which a preferential taxation regime is applied, including offshore zones.
- 5) Transactions with legal entities that enjoy tax exemptions or apply a tax rate, which differs from the rate established by the tax legislation.
- 6) Transactions with legal entities that have tax losses for the last two tax periods preceding the year of the transaction.

Other cross-border transactions are subject to transfer pricing regulations if the transaction price is lower or higher than the market price by more than 10 percent.

Please note that points 5 and 6 mentioned above will also be applicable to onshore transactions, provided that such transactions are connected with international business operations, which are defined as import/export transactions with respect to goods, works and services.

In order to exercise the transfer pricing rules, the tax authorities monitor certain types of transactions. The list of such transactions is established by a special resolution, which among others includes transactions in respect of crude oil, natural gas and refined products. The government has also issued a list of companies registered for tax purposes in Kazakhstan, which are subject to transfer pricing monitoring.

If the tax authorities are not able to determine the market price, they may use the cost-plus or resale-minus method.

On the basis of transfer pricing adjustments the tax authorities may assess:

- ! Principal income tax.
- ! Principal VAT and excise tax, if applicable.
- ! Principal royalties and excess profits tax (for subsurface users).
- ! Principal customs payments.
- ! Related penalties and interest.

Transfer pricing provisions stipulated in international agreements ratified by Kazakhstan prevail over the Transfer Pricing Law. □