

Legal Environment for Service Companies

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Prerequisites for the Development of Service Companies' Market

The oil and gas sector is the dominant sector in terms of attracting foreign investment into the Republic of Kazakhstan. In spite of the fact that the gross investment inflow into the oil and gas sector for the year 2003 represented approximately 20% of total inward investments, the government estimates that the volume of future investments into this sector will be over \$80 bln, including over \$32 bln for development of the Caspian Sea Sector belonging to Kazakhstan (2003-2005 – over \$ 6 bln; 2006-2010 – over \$10,3 bln; 2011-2015 – over \$15,6 bln). In this case, the processing industry, including petrochemistry and oil processing, would be preferential in the future policy of Kazakhstan.

Further development of the oil and gas sector in Kazakhstan will directly depend on successful implementation of public programs such as the program of Development of the Caspian Sea Sector belonging to Kazakhstan, Industrial and Innovation Development Strategy, and Regional Programs. Their realization will require the attraction of numerous service companies. In particular, the following services will be of high importance:

- 1) Prospecting and geophysical surveys;
- 2) The development of discovered fields and arrangement of production;
- 3) Drilling operations (over 1100 wells are planned to be drilled from platforms and artificial islands only before 2005, and over 70% thereof within the period of from 2011 through 2015) by contracting a great number of contractors and using the most up-to-date drilling rigs which meet international standards;
- 4) Development of building materials and engineering techniques to erect marine structures;
- 5) Construction work (from repair and construction of wells, pipelines, petrochemical facilities, vessels and dockyards – only in Tupkaragan Bay it is planned to base 75 various vessels – to construction of related infrastructures – roads, housing, hospitals, schools and recreational establishments);
- 6) Transportation development including overland, air transport and communication services;
- 7) Creation and development of off-shore and on-shore infrastructure;
- 8) Services of a commercial fleet (to carry out prospecting work it is required to construct/ lease/purchase towboats, transport and building barges, research vessels, civil aviation aircraft, air cushion mounted-vessels, fireboats, etc.), commercial fleet repair and maintenance services;
- 9) Creation of marine navigation control systems in accordance with the IMO guidelines;
- 10) Reconstruction and modernization of Aktau and Atyrau Airports;
- 11) Sulphur disposal (including the production of sulphur concrete, sulphur cement, sulphur asphalt and bitumen);
- 12) Development of petrochemical plants;
- 13) Gas disposal, increase and development of gas-transferring capacities, modernization of gas-distributing facilities, branching of gas mains and local gas-distributing networks and reconstruction of gas mains.

For most of the specified services and activities, the Government issues the privileges and preferences that are described in detail below.

The necessity for services in Kazakhstan is evident. But before any project is commenced, companies, particularly foreign ones, need to know the answers to a number of important questions:

- 1) What are the requirements for registration in the RK and what terms are best to elect?
- 2) What licenses and permits are required to carry out activities?
- 3) What is the fiscal policy of the Government of RK?

The answers to the primary questions relating to service companies operating in Kazakhstan follow.

Legal conditions for the operations of service companies

As you probably know, Article 63 of the RK President's Subsoil and Subsoil Usage Decree and Article 41 of the Oil Decree asset out the responsibilities of subsoil users:

- 1) **The subsurface user must** use materials and finished products **manufactured in the RK**, and
- 2) **The subsurface user must** contract the **Kazakhstani enterprises and entities** on a competitive basis to perform work (services), when oil operations are carried out.

The specified regulations predetermine the priority of Kazakhstani enterprises and entities as compared with foreign ones and, in light of this, it is favorable for foreign companies operating in the sector to create legal entities in the RK (whether with full or partial contribution to the Authorized Capital therein), instead of incorporation of the foreign entity's branch. Although, of course, in Kazakhstan there is no significant difference between the activity of the Kazakhstani legal entity and that of the foreign entity's branch. The requirements applied to both are the same: the necessity to license some activities, certify equipment, obtain various consents and permits from public authorities and the taxation procedure is practically the same (except in some minor respects).

The current economic and fiscal trend also gives priority to Kazakhstani enterprises: the Investments Act stipulates certain privileges and preferences for the legal entities of the RK. Nevertheless, considering that in the Kazakhstani market there are no domestic manufacturers of various equipment meeting international standards and that the number of qualified staff is insufficient, it is reasonable to contract foreign subcontractors.

The services rendered by foreign entities may be used on the following conditions:

- 1) Specific goods, work and services are available at only particular Kazakhstani or foreign enterprise and only particular Kazakhstani or foreign enterprise has exclusive rights with respect to such goods, work and services;

- 2) A client purchasing food, equipment, technologies or services from any seller must purchase from the same seller other goods, work and services on account of and in consideration of unification, standardization or necessity to ensure the compatibility with the available goods, equipment, technologies or services;

- 3) A tender is acknowledged as failure.

To hire a subcontractor on an uncompetitive basis, an entity is required to obtain a special permit (which differs from case to case) issued by the competent public authority (Ministry of Industry and Commerce of the RK).

Licensing of Service Companies' Activity

Regardless of their legal form (whether a legal entity of the RK or a foreign entity's branch incorporated in the RK), all entities (both resident and non-resident) must license some activities, obtain various permits, and certify their equipment. The procedure for issue of licenses, permits and equipment certificates, as provided for by the legislation, is not particularly complex so I will not dwell on it.

Financial Conditions for the Operations of Service Companies

Legal conditions for the subcontractors' activity may be divided into the following types:

- 1) Those stipulated in legislation;
- 2) Those provided for by subsoil usage contracts and production sharing agreements;
- 3) Those intended for priority economy sectors;
- 4) Those intended for FEA.

The conditions generally established by the legislation in respect to the subcontractors' activity in the oil and gas sector may include the following:

- ! Free use of income after taxation;
- ! Free to open account in Kazakhstan banks;
- ! Reimbursement of losses (resulting from state bodies' illegal actions);
- ! Restriction of nationalization and requisition;
- ! Free to determine an arbitration;
- ! Application of International Investment Supporting Agreements and Double Taxation Treaties.

These conditions are applied in practice to all sub-contractors, regardless of whether they are exposed to the stability of the subsoil usage contract concluded by the Client with the Government or the Competent Authority or registered in the Free Economic Area, or whether their activity is a priority activity approved by the Government of the Republic of Kazakhstan.

As for the conditions provided for by subsoil usage contracts and PSAs, there are, as a rule, stable and unstable conditions, as determined by the terms of the contract between the client and the competent authority. A number of subsoil usage contracts and PSAs concluded in the first half of the 1990s, as well as some contracts before 1998, provided for tax and customs privileges for the contractor itself (Subsoil User) and its subcontractors, and such privileges were mainly applied to the import and export of goods, materials and equipment required to carry out oil operations (a number of contracts specify an exhaustive list of such goods, materials and equipment).

Conditions provided for in the RK Investments Act of 8.01.03 with respect to subcontractors' activity and relating to priority economy sectors.

Pursuant to the specified Act investment preferences are granted within the first 5 years of an investment project in the form of:

- 1) Tax preferences (additional deductions from an average annual income, relief from land and property taxes);
- 2) Relief from customs duties (special exemption terms – no equipment production facilities and components or deficiency in their production, noncompliance with the requirements set within the investment project);
- 3) Public grants in kind (transfer of buildings, structures, machinery and equipment for ownership or land tenure) up to a maximum amount of no more than 30% of the scope of investments into fixed assets.

In this case, the specified privileges are of a target nature and granted only for the activities defined by the Government's Resolution No. 436 of 08.05.2003 as priority ones (the list of priority activities at the activity classifier level which, subject to investment preferences, has been approved by the above Resolution). Thus, for example, the priority activities specified in Resolution No. 436 include: the building of water constructions and other types of constructions,

production of commercial gases, rubber products, plastics used in the construction, manufacture of iron, steel and plastic pipes, building metal structures and items, manufacture of machinery and equipment for production of minerals and construction, construction and repair of vessels, exploratory drilling and activity of water (marine and river) transport (which is topical due to operations on shelf). The enterprises (namely the legal entities of the RK) engaged in specified activities are entitled to apply to the competent investment authority for a contract to implement the investment project and the specified privileges. Also, I would like to note, that to obtain investment preferences it is required to invest in the fixed assets of a legal entity (to create, extend and renovate production facilities), e.g. the creation of the Kazakhstani limited liability company, which becomes an owner, in any way whatsoever, of the drilling and other equipment required to carry out investment activity. The fixed assets may be transferred in various ways, including leasing. The government's economic and fiscal policy promotes the development of leasing relations by granting certain tax privileges to both foreign lessees and lessors in the form of exemption of the international leasing fee from VAT and income tax and additional deductions provided for the Kazakhstani lessor.

In accordance with the State Law on investments, subsoil use operations are not stipulated as priority activities. Moreover, according to the Tax code, investment tax preferences may not be applied to subsoil use operations.

Tax Treatment for the Special Economic Area

General treatment:

Enterprises engaged in the activities defined by the government are entitled to the following tax privileges:

- 1) Reduction of the Corporate Income Tax payable to the budget by 50%;
- 2) Zero Rate Property Tax;
- 3) Zero Rate Land Tax;
- 4) Exemption from VAT for some services.

The FEA is, in effect, a customs union (Article 12 of the RK FEA Act of 15.07.96), i.e. no non-tariff measures, customs duties and taxes, except excise taxes on imported goods and goods safety requirements may be imposed.

Special treatment for “Morport Aktau” FEA:

The enterprises engaged in the chemical and/or metallurgy industry, manufacture of rubber and plastic products, production of other non-metal mineral products, manufacture of ready metal items and the manufacture of machinery and equipment in the territory of “Morport Aktau” FEA are entitled to the following tax privileges:

- 1) Reduction of the CIT payable to the budget by 100% (i.e. full exemption from CIT);
- 2) Zero Rate Property Tax;
- 3) Zero Rate Land Tax.

Only certain types of goods, machines, materials and equipment are exempted from customs duties and VAT for import.

Apart from the existing “Morport Aktau” FEA, it is also planned to extend the FEA to Kuryk Port.

Potential Problems Related to the Activities of Service Companies

Despite the current governmental policy and all its positive aspects, there are also problems, including:

- 1) Barriers to obtaining permits to employ a foreign workforce. Pursuant to the President’s Decree of 16.05.03 “On state program for development of the Caspian Sea Sector belonging to Kazakhstan” the companies working in Kazakhstan should train 10 Kazakhstan citizens for every foreign worker employed (within the period of 2003-2005, with further replacement of foreign employees with local ones within 2005-2010). There is no restriction with respect to the number of the employed foreign workforce; however, the government approves a quota on an annual basis. As noted, the government is interested in construction services,

development of transport, including marine transport, exploration, geophysical and drilling operations, in particular on the shelf, and other work and services, in which the Kazakhstani specialists are either insufficiently qualified or not represented at all. Moreover, the quota approved by the Government is determined, as a rule, based on the current data of local authorities (i.e. based on the current number of permits issued) and, frequently, does not take into account foreign companies coming to Kazakhstan for the first time.

- 2) The avoidance of double taxation and the application of International Conventions. Problems lie in the definition and the establishment of the nonresident’s permanent residence, delay on the part of the tax authorities in consideration of the nonresidents’ applications to apply the convention provisions, and the tax authorities’ demands to submit additional documents not required by the Tax Code.
- 3) The impact of “main” contracts on subcontracts, i.e. the provisions of subsoil usage contracts are applied to the relations with subcontractors (in particular, some privileges and exemptions specified in the contracts are applied to the subcontractors, but the public authorities do not always agree to comply with the provisions of subsoil usage contracts).
- 4) The Influence of KMG on the selection of subcontractors in particular with regard to its affiliates.
- 5) Spreading of provisions of the Law on State Purchases to some oil producing companies. According to Article 1 of the Law on State Purchases this law applies to the purchase of goods, works and services by KazMunayGas and its affiliates but not by affiliates of KMG’s affiliates. State authorities very often disregard this provision. □