

The Taxation of Production Sharing Agreements in the CIS

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Azerbaijan

Azerbaijan's oil and gas industry is historically considered to be one of the most strategic and important sectors of the domestic economy. The revenue generated constitutes a major share of the country's budget. In terms of experience in applying the PSA regime to the oil and gas industry, Azerbaijan is a world leader. There are more than 20 PSAs between the State Oil Company of the Republic of Azerbaijan and well known foreign oil and gas companies. In contrast to the practice in other CIS countries, each signed PSA has the status of law and prevails over conflicting statutory tax legislation. The PSA regime offers maximum protection against future adverse changes in the investment regime and therefore, plays a significant role in fostering the development of the domestic economy.

PSAs in Azerbaijan stipulate special taxation rules for foreign subcontractors working under a PSA. In accordance with the tax legislation, PSA contracting parties are subject only to profits tax and social security contributions with respect to local employees and are exempt from all other taxes, including mineral tax. The following rules apply to PSA participants:

! Profits Tax: Under a PSA, contractor parties carrying out business in Azerbaijan in connection with petroleum operations are subject to a tax on profits. The profit tax rate is negotiated and varies from 25% to 32%, depending on the PSA. The PSA provides de-tailed definitions of each item of income and deductible expense and, therefore, shows a clear mechanism for profit and loss accounting. Losses incurred by contracting parties which are subject to the provi-

sions of a PSA are deductible once production commences.

! Withholding Tax: A PSA provides for simplified tax rules for foreign subcontractors supplying goods and services in respect of the PSA. Foreign subcontractors pay withholding tax at rates ranging from 5 to 8% based on gross payments received for work or services carried out in Azerbaijan. This tax must be withheld by the person making a payment to the foreign subcontractor and remitted to the State Budget.

! Personal Income Tax: Personal income tax of local employees of contracting parties, their affiliates and foreign subcontractors is calculated in accordance with the statutory tax legislation. The personal income tax of foreign tax resident employees is calculated based on income earned as a direct result of employment in Azerbaijan. Foreign employees who do not become tax residents do not pay Azerbaijan personal income tax.

! Value Added Tax: The supply of goods, works and services to and by contracting parties and foreign subcontractors in connection with a PSA is exempt from VAT, but taxpayers are allowed VAT credits. In addition, imports and the acquisitions of goods, work and services are subject to 0% VAT.

! Customs Duties: All imports made in connection with a PSA are exempt from customs duties. Contracting parties and foreign subcontractors may obtain an exemption certificate from import/export duties issued by the State Customs Committee.

One of the positive factors of the PSA regime has been the creation of a favorable business climate, resulting in a substantial inflow of foreign investment. According to reports published by international finance organizations, Azerbaijan is among the leading countries in attracting direct foreign investment, which should help to stimulate other business and industry sectors as well.

However, although obvious advantages can be gained from a PSA (such as easy to follow and simplified taxation rules, a feature that is attractive to foreign investors), some tough issues remain. For example, the advantageous PSA tax regime gives rise to complexities for companies engaged in both PSA and non-PSA operations (e.g. expense allocation issue), since non-PSA sales are subject to taxation under the general tax regime.

Another disadvantage of the PSA regime is its disparity of treatment of local and foreign subcontractors — foreign subcontractors are subject only to withholding tax, whereas local subcontractors are subject to full taxation.

On balance, however, Azerbaijan's PSA experience thus far has been positive. Although it has some drawbacks that require improvement, the PSA regime has had a beneficial influence on the growth and strengthening of Azerbaijan's economy.

Georgia

About 15 PSAs have been concluded in Georgia to date.

A PSA does not have legal force, nor does it prevail over statutory law in Georgia. The terms of a PSA relating to taxation of the participants must comply with the legislation governing the taxation of companies in the oil and gas sector. However, investor rights are protected, and any amendments to statutory law (including the Tax Code) that adversely affect investment conditions do not apply to existing PSAs — the rates set forth in the PSA at the time the agreement was signed remain applicable.

Petroleum taxation in Georgia is governed by two pieces of legislation: the Tax Code and the 1999 Law on Oil and Gas. Although the Tax Code does not contain specific provisions governing the taxation of PSAs (the term "PSA" is not even found in the Code), it does include rules for the taxation of "oil and gas operations." That term is defined in the Oil and Gas Law and includes the exploration and production of oil and gas within an area specified in a PSA and activities connected with such operations (i.e. the gathering, treating and storage of produced oil and gas in the relevant area). Oil and gas companies that are not engaged in oil and gas operations are not entitled to enjoy the privileges and benefits granted by the Oil and Gas Law; such companies are subject to taxation in accordance with the Tax Code.

In Georgia, equipment or structures, drilling equipment or ships used for surveying natural resources are deemed to create a permanent establishment (PE) of a foreign company that is a party to a PSA, which gives rise to profits tax liability calculated at the general profits tax rate. However, this provision does not apply to non-resident subcontractors of parties to a PSA carrying out oil and gas operations. Such subcontractors are subject

to taxation at source on gross income at a reduced rate of 4% and their activities do not give rise to a PE.

In accordance with existing PSAs, contracting parties carrying out business in Georgia are subject to profits tax at a rate of 20% and tax on the use of mineral resources. However, profits derived from petroleum operations under older PSAs (i.e. those signed before 1 January 1998) are taxed at a rate of 10%. Expenses incurred on geological research, preparation for the mining of natural resources and drilling are deductible in accordance with the norms set forth by the PSA. Under the Tax Code, certain transactions conducted in accordance with the Oil and Gas Law (and if carried out under a PSA) are exempt from taxation as follows:

- ! **VAT and Customs Duties:** Import of machinery, means of transportation, spare parts and materials for oil and gas operations, as well as the supply of goods (works, services) required for oil and gas operations by investors and operating companies;
- ! **Excise Tax:** Import and/or supply of oil products necessary to conduct oil and gas transactions specified in the Oil and Gas Law;
- ! **Property Tax:** Property needed for oil and gas operations;
- ! **Land Tax:** Land plots used for carrying out oil and gas transactions under the Oil and Gas Law (if not used for other purposes); and
- ! **Social Taxes:** Income of foreign individuals hired for oil and gas projects.

Although, under Georgian tax rules, it is the sole liability of each taxpayer to pay all taxes due, tax liabilities arising under a PSA may be assigned in certain circumstances. The party to a PSA that represents the state of Georgia is the (JSC) Georgian Oil Company. In practice, it may act as a tax agent of another participant to a PSA and remit its taxes to the budget (e.g. tax on the extraction of mineral resources), withholding the necessary amounts from that participant's production share.

The Georgian Tax Code does not provide specific tax accounting rules for a PSA, such as a requirement to maintain a separate accounting of operations. The Oil and Gas Law, however, requires the accounting records of the operating company to be maintained in accordance with international accounting standards.

Ukraine

The concept of PSAs was introduced in Ukraine in 1999 with the adoption of the Law on Production Sharing Agreements, which was aimed at facilitating investment into the extraction of minerals. The Production Sharing Law introduced favorable conditions and a number of tax benefits for investors engaged in mineral extraction under PSAs. However, due to the absence of specific procedures for executing and implementing PSAs, there is not much practical experience with such agreements. It is still more common for investors to operate under the general taxation regime or be subject to taxation under agreements on joint activities carried out by foreign investors with state oil and gas companies.

According to the Production Sharing Law, a PSA envisages an agreement between the State and private investor(s) (which may include one or more foreign investors), whereby the investor undertakes the exploration, exploitation and extraction of mineral resources within the allocated block at its own expense and at its own risk, with the State subsequently compensating the investor for its expenditure in the form of a specified share of the oil production. A PSA may be concluded with respect to subsurface lots included in a list approved by the Cabinet of Ministers. To be included on the list, subsurface blocks must meet specific, complex requirements, although an investor may request that the Cabinet include a specific subsurface block in the list. Production must be divided between the State and the investor on a quarterly basis and in the manner stipulated in the PSA. Cost oil may not exceed 70% of total production in any given period.

Under the Production Sharing Law, the investor is subject to corporate income tax (CIT), VAT at the standard rate of 20%, the levy on geological exploration works performed at the cost of the State (payable in amounts determined by the PSA), mandatory employee state social insurance payments, pension fund levies and subsurface utilization payments (payable in amounts determined by the PSA).

CIT must be paid by the investor at the general rate of 25%, subject to the following conditions:

CIT may be paid in monetary and or non-monetary form, i.e. in kind;

- ! The CIT tax base is calculated based on the hydrocarbons transferred to the investor under the PSA (i.e. cost oil plus profit oil) with the de-

duction of obligatory taxes and payments (as enumerated above except for CIT);

- ! Losses may be deferred to future tax periods without limitation;
- ! The PSA may set depreciation rates different from those provided in the applicable legislation; and
- ! Income derived by a foreign investor under a PSA is not subject to withholding tax.

The investor and any contractors, suppliers etc. engaged by the investor to carry out the PSA are (1) exempt from customs duties and VAT on goods, works or services imported for the purposes of carrying out the PSA; and (2) exempt from customs (except for customs processing charges), excise and other taxes on the export of hydrocarbons produced under the PSA, although such products are subject to VAT at a rate of 0% (so input VAT may be recovered).

Investor protection is available so that if subsequent changes to the tax law are introduced, the privileges granted under a PSA at the date of signing remain valid.

Uzbekistan

PSAs in Uzbekistan are regulated by the 2001 Law on Production Sharing Agreements. A PSA is defined as a contract under which the Republic of Uzbekistan grants a foreign investor (at his own risk and expense) exclusive rights to the exploration, prospecting and production of resources at a subsurface area specified in the agreement, and to carry out related works for a specified period of time.

Subsurface deposits may be the subject of a PSA if:

- ! The government has neither the financial nor the technical means to develop large explored resource deposits, where the development of minerals recovered is necessary for the economic stability of the country; or
- ! Specific advanced technologies are needed for the development of hard-to-extract but extensive resources located in complex geological structures or remaining on previously developed fields; or
- ! It is necessary to improve the efficiency of mineral recovery or prevent possible adverse social or environmental consequences.

Subsurface blocks may be developed under PSAs based on the results of public tenders unless otherwise provided by legislation. According to the government, in some circumstances, PSAs can be executed without a public tender, through direct negotiations.

The State Committee on Geology and Mineral Resources is responsible for granting rights to develop subsurface plots and reviewing PSAs. In practice, a special joint resolution is made on each PSA by the State Customs Committee, the Ministry for Foreign Economic Relations on Investments and Trade, and the Ministry of Economy, approving the terms for customs clearance of commodities imported into or exported from Uzbekistan under a PSA.

Each resolution provides for special tax regimes and customs clearance procedures for the import or export of goods. In particular, investors, as well as their contractors and subcontractors, are exempt from all taxes, levies and payments related to prospecting and exploring subsurface zones stipulated by the PSA. If the investor carries out other types of business activities during the term of a PSA, the investor pays only corporate income tax, land tax, tax for use of water resources and for the use of subsoil. The investor is exempt from all other taxes, levies and payments.

Goods, works and services provided by resident entities to investors or/and operators working under a PSA are subject to a zero-rate VAT. Goods, works and services intended for the performance of work under a PSA and imported by the investor or other entities involved in the PSA, as well as products exported by the investor (and owned by the investor under the PSA), are exempt from customs duties, except for customs clearance service fees.

All projects implemented under a PSA are included in targeted investment programs to be financed by direct foreign investment and loans. Industrial enterprises with foreign participation investing in such programs enjoy major tax benefits, in particular, a profits tax exemption for seven years from the date of registration of such entities.

Uzbekistani tax law provides PSA investors with protection against future adverse changes in the tax regime. PSA contractors and their operators are entitled to recover "allowable" costs, as determined by the Cabinet of Ministers, and the procedure for their calculation is stipulated by the relevant PSA. The mechanism for splitting profit oil also is determined in the PSA, which means it is subject to negotiation rather than regulated by law. □