Oil and Gas Tax Guide*

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The Current State of Russia's Oil and Gas Industry

Russia is one of the world's major oil powers, with an oil and gas industry that is traditionally regarded as one of its key sectors, in that the income it generates accounts for a significant proportion of the state's budget revenue.

It is difficult to overestimate the importance of the oil complex for Russia's economy. Over the last three years the fiscal burden on the oil sector has increased one and a half times. Estimates indicate that in 2003, large oil companies had to pay approximately two thirds of their profits, and more than one third of their receipts, to the budget. The increased burden on oil and gas companies enabled the relative proportion of sectoral payments within Russia's GDP to grow from 4.3 percent in 2000 to 5.5 percent in 2003. The International Energy Agency estimates that in 2003, Russia should have received USD 53 billion from exports of oil and oil products alone.

Assessments and opinions as to the extent of Russia's proven oil reserves vary among specialists, official structures, and international organizations.

According to the last yearly statistical review of world energy made by BP on the basis of data in the Oil & Gas Journal, the quantity of proven reserves of raw hydrocarbons in Russia in 2002 increased by 23 percent to 8.2 billion metric tons, which was around 6 percent of the world's total reserves and put Russia in seventh place worldwide. It must be noted that the figure given for BP's estimate of Russia's reserves of raw hydrocarbons only included the reserves of the six largest oil companies. Reserves of other mining structures and of the state did not come within the field of vision of the international auditors.

At the same time, Russian experts estimate that the quantity of Russia's proven reserves of raw hydrocarbons is somewhere between 10 billion and 13.5 billion metric tons, which places Russia in third place globally in terms of proven reserves. Russia is also rich in potential reserves of raw hydrocarbons. These potential reserves are indicated by the results of geophysical investigations but have not been confirmed by samples obtained by drilling. The table below presents information on the distribution of hydrocarbon reserves among Russia's regions (see Table 1).

Table 1. **Oil-Bearing Provinces of Russia and Hydrocarbon Reserves, billions of metric tons**

Region	Proven Reserves	Potential Reserves
Timano-Pechora Region	1	1
Ural-Volga Region	2	No data
North Caspian Region	0.3	No data
Western Siberia	9.1	No data
Eastern Siberia	No data	2
Chukotka	No data	1
Kamchatka	No data	1
Sakhalin	No data	1

Source: Expert magazine (No. 27-28 of 21.07.2003)

The last four years have witnessed a veritable boom in Russia's oil industry: since 1999 the volume of extraction has increased by 34 percent, and in terms of the level of extraction, at 8.3 million barrels a day (as at July 2003), Russia has been second only to Saudi Arabia. The increase in oil extraction by Russian companies was caused by a substantial leap in world oil prices and a corresponding increase in exports, which has grown at an even faster pace than actual extraction. In addition, the growth in Russian extraction levels was also aided by significant investments made by major Russian oil extractors in hydrocarbon exploration and extraction.

Oil extraction in Russia in 2002 rose to 380 million metric tons compared with 348 million metric tons in 2001. The five largest oil companies (Lukoil, Yukos, Surgutneftegaz, TNK, and Sibneft) accounted for 262 million metric tons (69 percent of total Russian oil extraction), while the correspond-

* To be continued in the next issue.

ing figure in 2001 was 234 million metric tons (67.2 percent). See Table 2.

According to information from the Energy Ministry published by Reuters, oil extraction in Russia in the first eight months of 2003 grew by 11.2 percent and amounted to 275 million metric tons, thus confirming the upward trend already observed from the results for the first seven months. The highest growth rates were shown by Sibneft and Yukos, with 22 percent and 18 percent respectively. TNK had a growth rate of a little over 10 percent, Surgutneftegaz around 15 percent, and Lukoil 3.4 percent.

Table 2. **Oil Extraction by the Largest Vertically Integrated Oil Companies in 2001-2002, millions of metric tons**

Companies	2001	2002	+/-against 2001
Lukoil	78.5	80.1	2.1%
Yukos	58.4	69.6	19.2%
Surgutneftegaz	42.8	49.2	14.8%
TNK	34.1	36.8	8.0%
Sibneft	20.0	26.3	31.5%
Total	**234**	**262**	**12.1%**
Russia	348	380	9.2%

Source: company reports, State Statistics Committee of the Russian Federation

Legal Aspects of the Activities of Oil and Gas

COMPANIES BASIC LEGISLATION

At present, oil and gas companies may carry out activities in Russia on the basis of the "Law Concerning Subsurface Resources" (1992), the "Law Concerning Production Sharing Agreements" (1995), and other normative acts governing relations associated with the use and protection of land, waters, and the environment which arise in the course of the use of subsurface resources.

In accordance with Russian legislation, natural resources, including oil, gas, precious metals and minerals, underground waters, and other commercial minerals within the territory of the Russian Federation, are the property of the state. The right of possession, use and disposal of commercial minerals is under the joint jurisdiction of the Russian Federation and its constituent entities. Subsurface resources cannot be bought, sold, gifted, bequeathed, pledged or otherwise alienated. At the same time, the right to use subsurface resources may be alienated or transferred from one person to another in cases permitted by federal legislation.

The Law Concerning Subsurface Resources

The "Law Concerning Subsurface Resources" regulates relations that arise in connection with the geological study, use and protection of the subsurface resources of the territory of the Russian Federation. In accordance with the law, the development of subsurface resources can only be carried out on the basis of a license. The license contains information on the development site, the timing of activities and financial conditions, as well as other technical and economic information. In addition to payments for the right to use subsurface resources, companies which carry out activities on the basis of a license are obliged to pay standard taxes such as profits tax, VAT, etc.

The Law Concerning Production Sharing Agreements

The "Law Concerning Production Sharing Agreements" establishes that the extraction of mineral resources and other relevant activities are to be regulated by a special individual agreement to be concluded between a company (investor) and the state. That agreement is essentially a contract between the state and an investor and is designed to regulate their mutual relations in the areas of tax, currency and customs legislation, and should ensure stability in those relations.

LICENSING

In accordance with the "Law Concerning Subsurface Resources," a license is a document which certifies the right of its holder to use a site of subsurface resources within specified boundaries in accordance with the purpose stated therein for a specified period and subject to compliance by the holder with predetermined conditions.

In particular, a license certifies the right to use a site of subsurface resources for the following types of activity:

- The performance of work involving the geological study of subsurface resources.
- The development of deposits of commercial minerals.
- The use of waste products of mining and related processing works.
- The use of subsurface resources for purposes not associated with the extraction of commercial minerals.
- The establishment of specially protected geological sites.

! The collection of mineralogical, paleontological and other geological specimens.

Subsurface resources may be provided for use for more than one type of activity at once.

The provision of a site of subsurface resources for use on the basis of a production sharing agreement is similarly formalized by a license to use subsurface resources. The license certifies the right to use a specified site of subsurface resources in accordance with an agreement that sets out all the significant conditions of use of the subsurface resources.

Sites of subsurface resources are provided for use for the following time periods:

! For geological study – for a period of up to five years.

! For the extraction of commercial minerals – for the period required to work out a deposit of commercial minerals as calculated on the basis of a feasibility study for the development of the deposit of commercial minerals, which provides for the rational use and protection of subsurface resources.

! For the construction and operation of underground installations not connected with the extraction of commercial minerals; for the construction and operation of underground installations connected with the burial of waste; for the construction and operation of oil and gas storage facilities, and for the establishment of specially protected geological sites and for other purposes – for an indefinite period.

The period of use of a site of subsurface resources may be extended if it is necessary to complete the development of a deposit of commercial minerals or to carry out abandonment operations. In the case of a production sharing agreement, the procedure for extending the period of use of a site of subsurface resources is determined by the agreement itself.

Taxation of Companies of the Oil and Gas Industry

Extraction and processing companies are liable to profits tax and VAT according to the standard procedure in addition to all the specific taxes and allocations which are established for oil and gas extraction enterprises by the Tax Code, the "Law Concerning Subsurface Resources" and other legislative acts. It may therefore be asserted that enterprises in the oil and gas sector have an additional tax burden compared with enterprises in other sectors.

This chapter describes the tax regime effective in Russia from January 1, 2004.

PAYMENTS FOR THE RIGHT TO USE SUBSURFACE RESOURCES

In accordance with current legislation, the system of payments associated with the use of subsurface resources is as follows:

! One-time payments for the use of subsurface resources.

! Regular payments for the use of subsurface resources.

! The charge for geological information concerning subsurface resources.

! The fee for participation in a competitive tender (auction).

! The fee for the issue of licenses.

These payments are incurred by all legal entities which carry out exploration, prospecting and the extraction of commercial minerals within the territory of the Russian Federation, its continental shelf and the maritime exclusive economic zone.

One-Time Payments for the Use of Subsurface Resources

One-time payments for the use of subsurface resources are levied upon the occurrence of particular events specified in the license. The minimum rates of one-time payments are established at not less than 10 percent of the amount of tax on the extraction of commercial minerals calculated on the basis of the average annual planned capacity of an extraction organization. One-time payments are payable upon the occurrence of particular events specified in the license in accordance with the procedure established in the license.

The rates of one-time payments for the use of subsurface resources and the procedure for the payment thereof in the context of production sharing agreements are established in the production sharing agreement.

Regular Payments for the Use of Subsurface Resources

These payments are levied for the provision to users of subsurface resources of exclusive rights to explore and appraise deposits of commercial minerals, prospect for minerals, carry out geological studies, and assess the suitability of sites of subsurface resources for the construction of installations not connected with the extraction of commercial minerals (with the exception of shallow-depth engineering installations).

- Regular payments are not levied on users that carry out the following activities:
- The use of subsurface resources for regional geological studies.
- The use of specially protected geological sites or scientific, cultural, aesthetic, sanitary or other value.
- Prospecting for commercial minerals on deposits put into commercial operation within the boundaries of a mining allotment that has been granted to the user of subsurface resources for the extraction of those commercial minerals.
- Prospecting for a commercial mineral within the boundaries of a mining allotment which has been granted to the user of subsurface resources for the extraction of that commercial mineral.

The amounts of regular payments for the use of subsurface resources are determined depending on the economic and geographical conditions, the size of the site of subsurface resources, the type of commercial mineral, the duration of the work, the degree of previous geological study of the area, and the level of risk. The rate of the regular payment for the use of subsurface resources is established per one square kilometer of the area of the site of subsurface resources. Payment is made quarterly on the basis of the area of the licensed site granted to the user of subsurface resources, less the portion of the licensed site that has been returned. The minimum and maximum rates of regular payments for the use of subsurface resources are established by the "Law Concerning Subsurface Resources."

The amounts of regular payments for the use of subsurface resources and the conditions and procedure for the levying of those payments in the case of production sharing agreements are established by the agreements within limits prescribed by the government of the Russian Federation.

The Charge for Geological Information Concerning Subsurface Resources

The charge for geological information concerning subsurface resources is levied for the use of geological information obtained from the Russian Ministry of Natural Resources. The amount of the charge for such data and the procedure for the payment thereof are established by the Russian government. In the case of production sharing agreements, the amount of the charge is established by the agreement.

TAX ON THE EXTRACTION OF COMMERCIAL MINERALS

This tax is levied with effect from January 1, 2002 in accordance with the provisions of Chapter 26 of the Tax Code of the Russian Federation – "Tax on the Extraction of Commercial Minerals."

The tax is levied on commercial minerals extracted from the subsurface within the territory of the Russian Federation or in territories under the jurisdiction of the Russian Federation (including territories which are leased from foreign states or used on the basis of an international agreement). Among the types of extracted commercial minerals are raw hydrocarbons, which include:

- Dewatered, desalted and stabilized oil.
- Gas condensate from all types of deposits which has undergone separation and dewatering operations and operations involving the separation of light fractions and other impurities.
- Natural fuel gas from all types of deposits, and associated gas. The tax base is determined as the value of extracted commercial minerals, as calculated on the basis of the volume of extracted commercial minerals and the valuation method used, or as the quantity of the extracted mineral in physical terms (in the case of oil, associated gas and natural gas).

The taxpayer has the right to determine the quantity of the extracted commercial mineral by either of the following:

- The direct method (by means of using measuring devices and equipment).
- The indirect method (on the basis of indicators relating to the content of the extracted commercial mineral in the mineral raw materials recovered from the subsurface).

It should be noted that the direct method has priority, as the indirect method can only be used when it is impossible to use the direct method.

The value of commercial minerals may be determined by the following methods:

- On the basis of the sell price prevailing for the taxpayer in the relevant tax period, without taking into account state subsidies to cover the difference between the wholesale price and the calculated value of mineral raw materials.
- On the basis of the sell price of the commercial mineral prevailing for the taxpayer in the relevant tax period, less VAT, excise duty on excisable types of mineral raw materials, customs du-

ties, transportation costs, and insurance premiums for compulsory freight insurance.

! On the basis of the calculated value of the extracted commercial minerals as determined using data in tax records which are maintained according to the rules established by Chapter 25 of the Tax Code of the Russian Federation – "Tax on the Profit of Organizations" (if it is impossible to use any of the preceding methods).

The rate of tax on the extraction of raw hydrocarbons is established at 16.5 percent of the taxable base. For gas condensate the rate of tax is 17.5 percent.

For the period from January 1, 2002 until December 31, 2006 the legislation lays down transitional provisions according to which, from January 1, 2004 until December 31, 2006, the taxable base for the tax on the extraction of commercial minerals is determined as the quantity of extracted oil in physical terms and is taxable at the rate of 347 rubles per metric ton. In this respect, the tax rate is adjusted quarterly for a coefficient reflecting movements in world prices for Urals oil.

This coefficient is determined by the taxpayer itself according to the formula:

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

where P is the average price level of Urals oil for the tax period in US dollars per barrel; R is the average value for the tax period of the exchange rate of the US dollar to the Russian ruble as established by the Russian Central Bank.

From January 1, 2004, the tax base arising from the extraction of natural and associated gas is determined as the quantity of the extracted mineral, to which the following rates are applied:

! Natural gas – 107 rubles per 1,000 cubic meters;

! Associated gas (gas extracted via an oil well) – 0 rubles

The amount of tax on the extraction of commercial minerals is calculated as the product of the tax base and the appropriate tax rate. The amount of tax is calculated monthly for each extracted commercial mineral. Tax is payable at the location of each site of subsurface resources which has been provided to the taxpayer for use. In this respect, the amount of tax is computed based on the proportion of a commercial mineral extracted on each site of subsurface resources to the total quantity of that type of commercial mineral that has been extracted. The amount of tax calculated in respect of commercial minerals extracted outside Russia is payable at the location of an organization or at the place of residence of a private entrepreneur.

In the context of production sharing agreements, tax on the extraction of commercial minerals is calculated with account taken of the special considerations set out in Chapter 26.4 of the Tax Code of the Russian Federation – "The Taxation System in the Context of the Performance of Production Sharing Agreements."

EXCISE DUTIES IN THE OIL AND GAS INDUSTRY

In 2004 the list of excisable goods includes the following oil products: petrol, diesel fuel, motor oils for diesel and/or carburetor (injection) engines, and straight-run petrol. Excise duties are levied on the following operations involving the receipt of oil products:

! The recording in accounts by an organization or private entrepreneur (which does not possess a certificate) of oil products that have been independently produced from own raw materials and other materials (including excisable oil products), and the receipt of ownership of oil products in payment for services involving the production of oil products from customer-supplied raw materials and other materials.

! The receipt or acquisition of ownership of oil products by an organization or private entrepreneur (which possesses a certificate); the recording in accounts of oil products independently produced from own raw materials and other materials and oil products received by way of payment for services involving the production thereof from customer-supplied raw materials and other materials, and the receipt by the owner of raw materials and other materials of oil products produced from those raw materials and other materials on the basis of a processing agreement.

! The transfer by an organization or private entrepreneur of oil products produced from customer-supplied raw materials and other materials (including excisable oil products) to the owner of those raw materials and other materials where that owner does not possess a certificate. The transfer of oil products to another person on the instruction of an owner shall be equated with the transfer of oil products to the owner.

Thus, the obligation to calculate and pay excise duty accrues not to the organization which has sold excisable oil products but to the organization which has received those excisable oil products. Taxpayers have the right to deduct amounts of excise duty charged when they receive a certificate of registration of a person which carries out operations involving oil products, which is issued by the tax authorities.

Certificates of Registration of a Person Which Carries Out Operations Involving Oil Products

Taxpayers that carry out operations involving oil products receive certificates of registration according to the type of activity:

- Production of oil products – a production certificate.
- The wholesale sale of oil products a wholesale sale certificate.
- The wholesale and retail sale of oil products – a wholesale and retail sale certificate.
- The retail sale of oil products – a retail sale certificate.

Certificates are issued subject to compliance with the following requirements:

- **A production certificate** – provided that the organization or private entrepreneur has ownership of facilities for the production, storage and supply of oil products.
- **A wholesale sale certificate** – provided that the organization or private entrepreneur has ownership of facilities for the storage and supply of oil products and/or subject to the existence of an agreement on the rendering of services involving the processing of crude oil, gas condensate, associated petroleum gas, natural gas, oil shale, coal and other raw materials and products of the processing thereof belonging to the taxpayer and/or subject to the existence of an agreement on the rent of facilities which are state property (for joint stock companies in which the state's share in the charter capital is not less than 50 percent).
- **A wholesale and retail sale certificate** – provided that the organization or private entrepreneur has ownership of facilities for the storage and supply of oil products and fixed fuel-dispensing pumps and/or subject to the existence of an agreement on the rent of facilities which are state property (for joint stock companies in which the state's share in the charter capital is not less than 50 per cent).
- **A retail sale certificate –** provided that the organization or private entrepreneur has ownership of facilities for the storage and supply from fixed fuel-dispensing pumps of oil products (with the exception of motor oils for diesel and/or carburetor (injection) engines) and/or facilities (premises) for the storage and sale of motor oils.

It should be noted that a certificate may be obtained not only by an organization which owns the relevant facilities, but also by an organization which owns more than 50 percent of the charter (pooled) capital of such an organization or more than 50 percent of the voting shares in such an organization.

Legal entities that do not have appropriate certificates do not have the right to deduct amounts of excise duty charged.

In the case of the sale of oil products, deductions may be made only for amounts of excise duty charged upon the receipt of oil products by a taxpayer which possesses a production certificate and/or a wholesale sale certificate and/or a wholesale and retail sale certificate when they are sold to a taxpayer which possesses a certificate (subject to the presentation of required documents).

Amounts of excise duty charged by a taxpayer who possesses a certificate for the retail sale of oil products, to the extent of amounts of excise duty charged upon the receipt of oil products which are allocated for retail sale (i.e., the supply of oil products through fuel-dispensing pumps), are not deductible.

Deductions are also made for amounts of excise duty charged by a taxpayer in relation to the excisable operations listed above when further use is made of excisable oil products, including when they are transferred to containers and/or blended. In addition, deductions are made for amounts of excise duty paid by persons possessing a certificate when excisable products are imported into the customs territory of the Russian Federation.

Excise duty is payable not later than the twenty-fifth of the month following a tax period which has ended. The tax period is a calendar month. However, taxpayers which possess only a wholesale sale certificate must pay excise duty no later than the twenty-fifth of the second month following a tax period which has ended, while taxpayers which possess only a retail sale certificate must pay excise duty no later than the tenth of the month following a tax period which has ended (see Table 3).

Table 3. **Rates of Excise Duties for Certain Types of Oil Products in 2004**

Types of oil products	Tax rates effective from January 1, 2004 (rubles per metric ton)
Petrol with an octane number of up to 8s0 inclusively	2,460
Petrol with other octane numbers	3,360
Oil for diesel and/or carburetor (injection) engines	2,732
Diesel fuel	1,000
Straight-run petrol	0

Operations involving oil products which are objects of assessment to excise duties are exempt from taxation provided that those oil products are placed under the export customs regime.

PROFITS TAX

The procedure for the calculation and payment of profits tax is regulated by Chapter 25 of the Tax Code of the Russian Federation – "Tax on the Profit of Organizations." Profits tax is one of the key budget-forming taxes and is a substantial payment from the point of view of the financial management of organizations and private entrepreneurs, which is why changes in the structure of the tax are of particular interest to tax authorities and taxpayers alike.

The object of taxation for profits tax is profit in the form of income received, reduced by the amount of expenses incurred which are determined in accordance with the provisions of Chapter 25 of the Tax Code of the Russian Federation.

Tax Accounting

For the purpose of calculating profits tax, organizations and private entrepreneurs must determine the tax base for each accounting (tax) period on the basis of tax accounting data.

Tax accounting is a system for the summarization of information for the purpose of determining the tax base for tax on the basis of data in primary documents that have been grouped in accordance with the procedure envisaged by Chapter 25 of the Tax Code of the Russian Federation.

In the event that accounting ledgers contain insufficient information to determine the tax base in accordance with the requirements of Chapter 25 of the Tax Code, organizations and private entrepreneurs (payers of profits tax) have the right independently to insert additional particulars in the accounting ledgers which are used, thereby creating tax ledgers, or to maintain separate tax ledgers. An important factor is the independent participation of taxpayers in the process of creating tax ledgers, taking into account the particular characteristics of the specific kind of activity carried out by the taxpayer. The procedure for the maintenance of tax records must be established by the taxpayer in its accounting policies for taxation purposes which are approved by an appropriate order (instruction) of the director. Tax authorities and other authorities do not have the right to establish compulsory forms of tax accounting documents for taxpayers.

Tax accounting data must reflect the procedure for determining the amount of income and expenditure, the procedure for determining the proportion of expenses which are taken into account for taxation purposes in the current tax (accounting) period, the amount of the balance of expenses (losses) which is to be charged to expenses in ensuing tax periods, the procedure for determining amounts of created reserves, and the amount of indebtedness in respect of tax settlements with the budget.

Income and Expenses

Chapter 25 of the Tax Code establishes two methods of recognizing income and expenses: the accrual-basis method and the cash-basis method.

When the accrual-basis method is used, income and expenses are recognized in the accounting (tax) period in which they occurred, irrespective of whether or not monetary resources, other assets (work and services) and/or property rights have actually been received. In the case of income which relates to two or more accounting (tax) periods and where the link between income and expenditure cannot be clearly defined or is defined indirectly, the taxpayer must independently allocate income taking into account the principle of evenness in the recognition of income and expenditure.

Under the cash-basis method, organizations (with the exception of banks) have the right to define the date on which income is received (an expense is incurred) according to the cash-basis method if, in the last four quarters, the amount of receipts from the sale of goods, works, and services of those organizations, excluding value added tax and sales tax, did not, on average, exceed one million rubles for each quarter.

For tax accounting purposes expenses are divided into direct and indirect expenses associated with production and sales, and direct and indirect expenses associated with trading operations.

Direct expenses associated with production and sales include material expenses, expenses associated with payment for the labor of staff involved in the process of the manufacture of goods, the performance of work and the rendering of services, including amounts of the unified social tax charged on those labor expenses, and amounts of amortization charged on fixed assets.

Indirect expenses include all other amounts of expenses, other than non-sale expenses, which are

incurred by the taxpayer during an accounting (tax) period. In this respect, the amount of indirect production and sale expenses incurred in an accounting (tax) period is fully included in expenses for the current accounting (tax) period.

The amount of direct expenses incurred in an accounting (tax) period is also included in expenses for the current accounting (tax) period, with the exception of amounts of direct expenses which are allocated to balances of work-in-progress, finished products in stock and goods dispatched, but not sold, in the accounting (tax) period.

In the case of wholesale, small wholesale and retail trade, direct expenses include the cost of bought-in goods sold in the accounting (tax) period in question and amounts of expenses for the delivery (transportation expenses) of bought-in goods to the warehouse of a taxpayer which purchases goods in the event that those expenses are not included in the acquisition price of the goods. All other expenses, with the exception of non-sale expenses that have been incurred in the current month, are deemed to be indirect expenses and reduce sales income for the current month. The amount of direct expenses attributable to balances of goods in stock is determined on the basis of the average percentage for the current month with account taken of the balance carried over at the beginning of the month.

Amortization

Amortizable assets are assets, results of intellectual activity, and other items of intellectual property possessed by a taxpayer as its property (with account taken of other provisions of the Tax Code) and are used by the taxpayer for the purpose of deriving income, and the value of which is written off by means of charging amortization. In this respect, amortizable assets are assets with a service life of more than 12 months and a historical cost of more than 10,000 rubles.

Land and other natural resource sites (water, subsurface resources and other natural resources), inventory, goods, incomplete capital construction projects, securities, and term transaction financial instruments are not subject to amortization.

Amortizable assets are allocated to amortization groups in accordance with their useful life. The useful life is understood to mean the period during which an item of fixed assets or an item of intangible assets can be used in achieving the goals of a taxpayer's activities. For example, the first group includes all short-life assets with a useful life of from one to two years inclusively; the fifth group includes assets with a useful life of over seven years and up to 10 years inclusively, and the tenth group includes assets with a useful life of over 30 years. The useful life is determined by a taxpayer independently as at the date on which the item of amortizable assets in question is brought into use in accordance with the provisions of the Tax Code and with account taken of the classification of fixed assets approved by the government of the Russian Federation. A taxpayer has the right to increase the useful life of an item of fixed assets after the date on which it is brought into use in the event that its useful life has increased following the reconstruction, modernization or retooling of the item. In this respect, the useful life of fixed assets may be increased within the limits of the periods which have been established for the amortization group in which the fixed asset was previously included.

The amount of amortization is determined by taxpayers for taxation purposes on a monthly basis in accordance with the procedure established by the Tax Code. Amortization is charged separately for each item of amortizable assets. For the purpose of calculating profits tax a taxpayer has the right to select the linear or non-linear method of charging amortization with account taken of the special considerations set out in the Tax Code. It should be noted that only the linear method of charging amortization may be used in relation to buildings, installations and transmission facilities which are included in the amortization groups eight, nine, and ten.

Where the linear method is used, the amount of amortization charged for one month in relation to an item of amortizable assets is determined as the product of its historical (replacement) cost and the amortization norm determined for that item. Where the non-linear method is used, the amount of amortization charged for one month in relation to an item of amortizable assets is determined as the product of the net book value of the item of amortizable assets and the amortization norm determined for that item. In this respect, from the month following the month in which the net book value of an amortizable asset reaches 20 percent of the historical (replacement) cost of that asset: the net book value of the item of amortizable assets for the purposes of charging amortization is set as its base value, and the amount of amortization chargeable for one month in relation to the item of amortizable assets in question is determined by means of dividing the base value of that item by the number of months remaining until the expiry of the useful life of the item (see Table 4).

Table 4. **Inclusion of Certain Fixed Assets Used in the Oil and Gas Industry in Amortization Groups**

Fixed Assets	Amortization Groups
Tongs; fishing tools for rectification of drilling accidents; tools and devices for sidetracking; drilling tools (other than rock-destruction tools); tools for screwing, unscrewing, and suspension of tubing and rods during repairs to development wells; fishing tools for development wells; tools for drilling of expendable wells: other tools for oilfield and geological prospecting equipment	**First group** (from one to two years)
Non-mechanized equipment and hand-operated apparatus for oxygen cutting of metals and replaceable machine cutters Special equipment for underground tunneling work and sampling; equipment for ensuring and monitoring safe working conditions Crosscut drills and winze sinking machines; raise boring machines; drilling rigs (self-propelled track-mounted drills); air drills (jackhammers)	**Second group** (over two years and up to three years inclusively)
Oilfield and exploratory drilling equipment Drilling, pile-driving and impact machinery and equipment Other equipment for mining works (drilling machinery air-powered percussion drills, mounted drilling equipment; machinery and equipment for charging and tamping of shot holes: mine rescue equipment; automated mine control, alarm and communication equipment and other equipment.)	**Third group** (over three years and up to five years inclusively)
Drilling rigs for development and deep-well exploratory drilling Equipment for gathering, recording, initial treatment and transportation of oil on fields Electric motors for electric drilling rigs; electric motors for cranes Tank trucks for transporting oil products, fuel and oils, and chemical substances	**Fourth group** (over five years and up to seven years)
Other power equipment, (technological equipment of gas pumping stations; special equipment for the assembly and repair of power equipment and thermal power systems)	**Fifth group** (over seven years and up to 10 years)
Development oil well Gas well for development drilling Installations of oil refining industry, including gas processing facilities	**Sixth group** (over 10 years and up to 15 years)

Tax Rate

The rate of profits tax is established at 24 percent of the taxable base. As from January 1, 2004 tax must be transferred to federal, regional and local budgets in proportions of 5 percent, 17 percent and 2 percent respectively. Legislative bodies of constituent entities of the Russian Federation have the right to reduce the tax rate for particular categories of taxpayers with respect to amounts of tax which are payable to the budgets of constituent entities of the Russian Federation, but not to below 13 percent. Thus, the minimum tax rate cannot be lower than 20 percent.

Special Considerations Relating to the Taxation of Foreign Organizations

Foreign legal entities which carry out entrepreneurial activities in the Russian Federation through a permanent establishment are liable to pay profits tax at the rate of 24 percent with respect to profit attributable to the activities of the foreign legal entity in Russia in accordance with Chapter 25 of the Tax Code.

Taxation of Foreign Organizations Which Carry Out Activities Through a Permanent Establishment. A permanent establishment of a foreign organization in the Russian Federation is understood to mean a branch, representation, division, bureau, office, agency or any other economically autonomous subdivision or other place of business of that organization through which the organization regularly carries out entrepreneurial activities within the territory of the Russian Federation.

The classification “permanent establishment” is a tax status connected with the presence of a foreign company in Russia. In order to acquire the status of a permanent establishment, the activities of a foreign company in Russia have to meet a number of criteria reflecting the duration and nature of the activities in Russia. Where a company carries out commercial activities over a short period of time, the results of those activities will

not be taxed in the Russian Federation. If the activities continue for a longer period of time, but are of a preparatory or auxiliary nature for the benefit of the head office, such activities will likewise not be taxed in Russia. Where the entrepreneurial activities of a foreign company in Russia give rise to a permanent establishment, profits tax will be levied on income received by that organization from activities carried out through the permanent establishment, reduced by the amount of expenses incurred by the permanent establishment; income received from the possession, use and disposal of assets of the permanent establishment less expenses associated with receiving that income; and other income from sources in the Russian Federation.

Taxation of Income of Foreign Legal Entities Which Do Not Carry Out Activities Through a Permanent Establishment. The following types of income received by a foreign organization from sources in the Russian Federation which are not connected with entrepreneurial activities carried out by the organization in the Russian Federation are subject to withholding tax:

- Dividends.
- Income received as a result of the distribution in favor of foreign organizations of profit or assets of organizations and other persons or associations thereof, including upon their liquidation.
- Interest income from any kind of debt obligation, including profit-sharing bonds and convertible bonds.
- Income from the use in the Russian Federation of rights to any kind of intellectual property.
- Income from the sale of shares (share interests) in Russian organizations, of which more than 50 percent of the assets consist of immovable property situated within the territory of the Russian Federation, and financial instruments derived from such shares (share interests).
- Income from the sale of immovable property situated within the territory of the Russian Federation.
- Income from the rental or sublease of assets which are used within the territory of the Russian Federation, including income from leasing operations and income from the rental or sublease of ships and aircraft and/or means of transport and containers used in international traffic.
- Income from international traffic.
- Fines and penalties for the violation of contractual obligations by Russian persons (state authorities).
- Other similar income.

The rates of tax on income of foreign organizations which is not connected with activities in the Russian Federation via a permanent establishment are established as follows:

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

A rate of 15 percent applies to the tax base determined for income received in the form of dividends with respect to income received by foreign organizations in the form of dividends from Russian organizations.

As at January 1, 2004 Russia had concluded double taxation treaties with 64 states. The provisions of those treaties include a special procedure for determining the status of the activities of foreign companies within the territory of the Russian Federation and a procedure different from that which is established by the Tax Code for the taxation of income of foreign companies from sources in the Russian Federation. According to the Constitution of the Russian Federation, where an international agreement of the Russian Federation establishes rules that differ from those contained in Russian legislation, the rules of the international agreement will apply.

Expenses Specific to Oil Companies

Chapter 25 of the Tax Code specifies two types of expenses relating to the development of natural resources: expenses incurred for the purpose of acquiring a license and expenses associated with the development of natural resources.

License Acquisition Expenses. Taxpayers which have decided to acquire licenses to use subsurface resources must reflect expenses incurred for the purpose of acquiring licenses separately in analytical tax ledgers. In this respect, expenses associated with the acquisition of each individual license must be recorded separately.

Expenses incurred for the purpose of acquiring a license include, in particular:

- Expenses associated with the preliminary appraisal of a deposit.
- Expenses associated with the performance of an audit of deposit reserves.
- Expenses for the preparation of a feasibility study (other similar work) and a project for the development of a deposit.
- Expenses for the acquisition of geological and other information.
- Expenses for the payment of fees for participation in a competitive tender.

Where, on the basis of the results of a competitive tender, a taxpayer concludes a license agreement for the right to use subsurface resources (receives a license), expenses incurred by the taxpayer in connection with the process of participation in the competitive tender make up the cost of the license agreement (license), which is included by the taxpayer in the composition of intangible assets.

Expenses for the Development of Natural Resources. The term "expenses for the development of natural resources" can be understood to mean expenditures of a taxpayer on the geological study of subsurface resources, on prospecting for commercial minerals, and on the performance of work of a preparatory nature.

In this respect, depending on the specific type of expenses, expenses are grouped as:

- General expenses for a developed site (deposit) as a whole.
- Expenses relating to individual parts of the area of a site under development.
- Expenses relating to a particular facility which is created in the process of the development of a site.

General expenses include, in particular:

- Expenses for the exploration and appraisal of deposits of commercial minerals (including audits of reserves), prospecting for commercial minerals and/or hydrogeological surveys which are carried out on a site of subsurface resources in accordance with licenses (permits) granted in accordance with the established procedure.
- Expenses for the acquisition of necessary geological and other information from third parties, including state bodies.

The amount of general expenses shall be recorded with respect to each part of the area of a site (deposit) which is under development in a proportion determined on the basis of the ratio of the amount of expenses relating to individual parts of the area of the site which is under development to the total amount of expenses which are incurred for the development of the site (deposit) in question.

Expenses relating to individual parts of the area of a site under development include, on the basis of primary accounting documents, in particular:

- Expenses for the preparation of an area for the conduct of mining, construction and other work in accordance with established requirements relating to safety and the protection of lands, subsurface resources and other natural resources and the environment, including the construction of temporary approach paths and roads for the removal of extracted rocks, commercial minerals and waste, the preparation of sites for the construction of appropriate facilities, the preservation of the fertile layer of soil which is intended for subsequent land recultivation, and the storage of extracted rocks, commercial minerals and waste.
- Expenses for the payment of compensation for complex damage inflicted on natural resources by land users in the process of the construction and operation of facilities, and the payment of compensation for agricultural production losses in the event that lands are appropriated for requirements not connected with agricultural production, and in the event of the destruction and impairment of deer pastures.
- Other expenses associated with the development of a part of the area of a site.

Expenses relating to a particular facility created in the process of the development of a site include expenses which are directly connected with the construction of installations which, on the basis of a decision of the taxpayer, may subsequently be recognized as permanently operated fixed assets. □