Some Disputed Issues Concerning the Application of Kazakhstan Tax Laws in the Subsoil Use Field

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Experience shows that the mining industry is one of the government's key areas of interest and, consequently, compliance by subsoil users with the Republic of Kazakhstan (RK) tax law provisions requires close attention from the competent government agencies.

Due to the complexity of the RK tax legislation and its greatly varying interpretations, that sphere, unfortunately, remains the single most frequent source of contention between the various subjects of the tax law relationship. Moreover, some ten years ago when the first major foreign investors came to Kazakhstan, which at the time had no codified market-oriented national tax legislation of its own, the subsoil use contracts then established special taxation regimes with various incentives and preferences whose term, as a general rule, extended over the entire life of the contract. Now, however, with the Kazakh national economy in a more stable position and a national tax legislation system in place, numerous issues have arisen concerning the application of those incentives and preferences and concerning the extension of the newer RK tax law provisions to the older subsoil use contracts.

In my report, I will address some of the current issues concerning the application of the RK tax legislation in the sphere of subsoil use.

On the whole, it is a welcome thing that the Republic of Kazakhstan now has a codified tax legislation system, with the single most important instrument there being the RK Code "On Taxes and Other Obligatory Payments to the Budget" (the "Tax Code"). It is quite in order that, as a single codified RK tax instrument, the Tax Code should govern relationships concerning the taxes and other obligatory government payments.

As part of my address, I would like to examine several RK Tax Code provisions, which regulate relationships concerning, in particular, the taxation of subsoil users (Section 10), environmental pollution payments (Chapter 83), land tax payments (Section 12) and land use payments (Chapter 81) and will discuss some points at issue regarding the application of those respective provisions.

Section 10 of the RK Tax Code[1] lays down procedures for the assessment and payment of:

1. excess profits tax; and
2. special subsoil use payments (bonuses, royalty, and the Republic's share in production or the additional payments made by respective subsoil users operating under a production sharing agreement).

It is not my intention here to comment on any of those provisions. I will only address some issues concerning their practical application. For instance, while under the earlier wording of Article 282.1 of the Tax Code[2], the specific tax treatment established for a given subsoil user was determined by its subsoil use contract made in accordance with procedure laid down by the RK Government, the newly amended wording stipulates no such provision. In the meantime, Article 42 of the RK Law "On Subsoil and Subsoil Use" provides that, when a subsoil use contract is concluded, the tax regime should be established in accordance with the RK tax legislation. At the same time,

[1] RK Tax Code as of 6 March 2005.

[2] See the provisions of Article 282 of the RK Tax Code in effect prior to the changes and amendments made by the RK Law #11 dated 13 December 2004.

pursuant to Article 282.2 of the Tax Code[3], in the case of the subsoil use contracts concluded before 1 January 2004 between the Republic or the competent government agency and a domestic or foreign subsoil user after the obligatory tax audit, the tax regime established at the time shall remain in force for the duration of the established term and can be adjusted by the parties' agreement in the event of subsequent changes in the Republic of Kazakhstan tax laws.

The following conclusions can be made from the above:

- the RK Tax Code has established clear-cut tax conditions for the subsoil users;
- tax conditions in the subsoil use contracts are established only in accordance with the RK tax legislation; and
- tax conditions in the subsoil use contracts made before 1 January 2004 shall remain valid and can only be changed by the parties' agreement.

Opinions have been expressed, however, in the corridors of power and by some among the legal scholars concerning the possibility of changing the tax conditions of the subsoil use contracts made before 1 January 2004. In my opinion, such a position is not likely to have a positive affect on the investment climate in the country and encroaches on the stability of respective contractual obligations of the parties.

There is an opinion, for instance, that where, as a result of changes in the RK tax legislation, the terms, for the Republic, worsen in the existing contracts, some of the contract's provisions should then be amended to restore the original balance of economic interests of the state[4]. Those voicing such an opinion also suggest that the same should be done if the terms and conditions for the subsoil users worsen compared with those in the existing contracts.

Such an interpretation contradicts the provision laid down in Article 282.2, RK Tax Code whereby the tax conditions in such contracts can only be changed by the parties' consent, something that obviously presupposes a mutual and voluntary agreement of the parties involved. Of itself, any changes in the balance of the economic interests of the state and/or the subsoil user cannot be accepted as a valid reason for changing the tax treatment, in the absence of voluntary agreement.

It should be noted here that, under the existing law (Article, 285.1.2, RK Tax Code), it is only possible to adjust the tax conditions in order to restore the Republic's economic interests in the production sharing agreements (known as the PSA's, for short 5) where the subsoil user's taxation conditions have improved. Whether it is fair or unfair to the subsoil users, that is the current legislative provision in effect.

Under the RK Tax Code, any adjustments in taxation conditions are possible only in respect of the PSA's and only where the subsoil user's tax burden has diminished. In all other subsoil use contracts, it is not possible to revise the established tax conditions without the parties' voluntary consent.

In the case of subsoil users already involved in the conduct of petroleum operations, it is not possible for the subsoil user's (contractor's) position to worsen, after the signing of the subsoil use contract, following any changes or amendments in the RK laws (see Article 57 of the RK Law "On Petroleum"). That provision fully applies to the tax regime established under such a contract.

By the way, the draft RK Law "On Production Sharing Agreements Concerning the Conduct of Off-shore Petroleum Operations"[6] under discussion now has no provisions allowing for the revision of the tax regime without the parties' voluntary consent. That is the correct approach, given that it is in the development of off-shore oil reserves that the future of the Kazakh economy lies. As that sector is going to require fresh investments, including those from foreign investors, tax provisions as proposed in the draft Law should be seen as a positive development.

There is also the mistaken, in my view, opinion that the state is entitled to some monetary compensation (pecuniary damage) where,

[3] See the existing wording of Article 282, RK Tax Code.

[4] See K. Safinov and V. Lebed, Commentary to the RK President's Decree Having the Force of Law "On Subsoil and Subsoil Use" (#2828) of 27 January 1996, Astana, 2000.

[5] The PSA's or Production Sharing Agreements.

[6] See RK Government Resolution 969 dated 16 September 2004 and the draft law referred to above.

under specified conditions[7], it has suffered losses as a result of reduction in the "tax on dividends"[8] (apparently, what is meant here is either the super profit tax or the tax on the nonresident legal entity's net income). In the opinion of the authors of that proposal, that should be done by raising the respective rates of other levies or taxes that are not covered by the provisions of the Chapter "Taxation of Subsoil Users"[9].

It is difficult to accept that view, as in that case the state would act as a *mala fide* party to the subsoil use contract, one that abuses its unlimited powers to change the respective provisions of the RK tax legislation by raising the rates on other types of tax or by increasing obligatory payments that lie outside the subsoil use sphere. In my opinion, that amounts to an indirect way of filling the government coffers at the expense of the subsoil users.

A few words now regarding royalty as a special form of payment established for the subsoil users.

From the sense and the actual wording of Article 295 of the RK Tax Code, it follows that the terms and procedures governing the payment of royalty should be stipulated in a given subsoil use contract and should not contradict any of the provisions of the RK tax legislation or other Kazakh laws.

The actual amount of royalty is determined based on the object of taxation, on the basis of estimate and on the published rate (Article 297, RK Tax Code).

By virtue of the above legislative provision, for the subsoil user to pay royalty, it is necessary to determine the following three obligatory constituents:

- the object of taxation — the actual volume of extracted mineral resources or the volume of the first commercial product generated from the mineral resources extracted;
- the tax base of royalty assessment — the value of mineral resources as determined by the RK tax laws; and finally
- the rate, the size of which is also established by the RK tax legislation.

It needs to be mentioned here that, as established by the Tax Code and other relevant RK legislative instruments, the specific size of the rates concerned applies to a specific and exhaustive list of mineral resources[10].

Turning to the specific provisions of Article 300, RK Tax Code, for instance, royalty on common mineral resources is paid at fixed rates according to the exhaustive list of common minerals.

In the meantime, the taxation practice in Atyrau Oblast has yielded some examples where the authorized government agencies had demanded that the subsoil users should pay royalty on the extraction of ordinary soil, the properties of which did not fit any of the specifications of common minerals on the list as established by the legislators.

To be fair, it should be said that the subsoil user concerned is not at all opposed to paying royalty on common minerals extracted or other materials mined, provided they are part of the approved list of common minerals. Given that, pursuant to the RK Constitution", the subsurface resources are state property and, as such, cannot be allowed to be exploited by business entities or individuals either for their own needs or for commercial purposes without charge or state control.[11]

What is required, therefore, is to eliminate the conflicting provisions of different legislative acts, bring them into uniformity and, finally, amend the existing tax legislation and other relevant RK laws accordingly so as to protect the state property and eradicate the uncontrolled use of subsurface resources.

Addressing the foundations underlying, and the procedure governing, the payment of royalty on the extraction of common minerals today, it is clear that the existing contradictions between the various legislative instruments are bound to result in disputes between the competent government authorities and the subsoil users.

[7] For example, following the implementation of an international agreement to eliminate double taxation resulting in the reduced rates of the excess profits tax.

[8] Neither the earlier tax legislation nor the existing tax laws make any reference to the "tax on dividends" as a form of tax and it would seem that the above theoretical interpretation of the term is one that had been developed by no other than the author of that idea himself.

[9] See K. Safinov and V.Lebed, Commentary to the RK President's Decree Having the Force of Law "On Subsoil and Subsoil Use" (#2828) of 27 January 1996, Astana, 2000.

[10] See, for instance, Article 297.4.1 and Article 300 of the RK Tax Code.

[11] SeeArticle 6 the Republic of Kazakhstan Constitution.

For instance, it follows, from the implications of the rules of Article 295 of the RK Tax Code, that royalty on subsoil use must be paid on the basis of a contract. It can be concluded that, in the absence of a contract, royalty should not necessarily be paid, for example, on common minerals extracted. What may lead the subsoil user to make such a conclusion is that there exist legal provisions that allow the subsoil users to extract common minerals for their own needs without concluding the contract[12]. What makes it possible for the subsoil users to take such a stand is the provisions of various other legislative instruments, which provide that a contract to extract common minerals should only be made where the extraction pursues purely commercial goals[13]. The subsoil users are not to be blamed for taking such a position, given that every businessman, whether a legal entity or a physical person, always is looking for ways to cut costs and, unless clearly bound to do so by the law, no one is going to make any payments on uncertain grounds.

Hence the conclusion that the respective provisions of the RK tax legislation and other laws governing relationships in the subsoil use sphere should all be brought into conformity. It is necessary to eliminate contradictions there and, at long last, to start effectively and lawfully to defend the interests of the state in the subsoil use sphere through the passage of fair and market-oriented regulatory instruments.

Some words are due here regarding the issues concerning environmental pollution payments, which are governed by the provisions of Chapter 83 of the RK Tax Code. Pursuant to Article 62 of the Tax Code, the environmental pollution fee is a form of obligatory payment to the government treasury and is subject to monitoring from the authorized RK tax authorities. In this particular area, even greater problems exist, which require urgent attention. Here then are some of them.

According to the provisions of Article 461 of the RK Tax Code, it is the actual volumes that should be subject to taxation, viz.:

- emissions within and/or above the prescribed thresholds;
- release (including emergency discharge) of pollutants;
- placement (storage) of production- or consumption-related waste materials.

As we see, the Tax Code establishes an exhaustive list of objects subject to environmental pollution payments.

It is appropriate here to recall another legal provision, viz. no one can be obligated to pay taxes or make any other obligatory payments to the government unless required to by the Tax Code (Article 2.2).

In connection with the latter legal provision, I would like to refer once again to the infamous Government Resolution 1154 dated 6 September 2001, which established departmental "Regulations Concerning the Issuance of Environmental Pollution Permits". Under the said Regulations, subsoil users were required, during the past three years, to make obligatory payments for "placing products or materials in the natural environment longer than three months", such products, by analogy, being assigned to the category of "production- or consumption-related waste materials".

However, under the provisions of the above Article 461, RK Tax Code, the object of taxation is the actually stored volume of "production-related waste materials" only[14].

It was not until 1 January 2005 that the new amended provisions of the RK Law "On Environmental Protection" had come into effect, offering a new legal interpretation of the terms "production-related waste materials" and "consumption-related waste materials" respectively. It was only then that the provisions of the above Regulations were brought into a measure of conformity with the respective provisions of the RK Tax Code.

A justified question is due here as to why the business entities concerned and, primarily, the subsoil users, for three long years, had to make payments for "storing products or materials

[12] See Article 47.3, RK Law "On Land" dated 24 January 2001; Article 42.1, the RK Land Code; and Article 13.4 of the RK Law "On Subsoil and Subsoil Use".

[13] See Clause 3 of RK Government Resolution #645 "Concerning the Establishment of a List of Common Mineral Resources" dated 26 May 1996 and the "Regulations Governing the Granting of Subsoil Use Rights in the RK" approved by RK Government Resolution #108 dated 21 January 2000.

[14] See the legislative interpretation of the term "production- or consumption-related waste materials" in the RK Law "On Environmental Protection" of 15 July 1997 in effect prior to the respective amendments in that Law made through the passage of RK Law #8 dated 9 December 2004 and RK Law #13 dated 20 December 2004.

in the natural environment longer than three months" just on the basis of a departmental act, albeit approved by the RK Government Resolution. Those payments amounted to billions of Kazakh Tenges. Who will compensate now the taxpayers for the losses suffered through that kind of abuse of governmental discretion?

It may well be that the long storage of some products or materials in the natural environment may, indeed, be harmful to the natural environment or public health. If that is the case and if that is corroborated with scientific research data, rather than just supported by common opinion or by the views of some incompetent government officials, why then had not the national environmental protection agency or the central government itself initiated appropriate amendments to the RK Tax Code and other laws, legislating a new kind of obligatory payment imposed on the long-term "storage of products or materials in the open environment"? Alternatively, they could have drafted new wordings of the respective concepts of "production-related waste materials" and "consumption-related waste materials".

It is felt that, in a nation seeking to build a law-governed state, no such thing should have happened even where the authors of the above Regulations may have sought to protect the environment or public health. The law should govern everything, while the respective government agencies, as subjects of a social relationship, should be the first to lead by the example of allegiance to the precepts of the law whatever the existing laws may be at any given time.

Concerning environmental pollution payments, the rates have grown every single year in an almost arithmetic progression. It would be very interesting to know, for instance, what scientifically-corroborated data and documents the elected members of Atyrau Oblast Legislative Assembly had, on the basis of which to approve the new environmental pollution fees at double the rate of those of the previous year. Were they truly guided by concern for environmental conservation and protection of public health or just saw that as an added means of supplementing the regional budget?

It is felt that the rates might indeed increase, but that should only happen on the basis of integrated studies of the condition of natural environment, the health of the local population, scientific research and, first and foremost, on the principles of justice and equity. Wholesale rate increases can only lead to the infringement of rights and legitimate interests of the nature users and can never help affirm the rule of law, in the broadest sense of that word.

A few words are in order here concerning the procedure and deadlines for environmental pollution payments. Under the provisions of Article 463.4 RK Tax Code, current payments for actual environmental pollution volumes have to be made by the taxpayer before the 20th of the month following the reporting quarter. The only exception to the general payment procedure is allowed in the case of the organizations with small total payment bills, the individual farm households and the agricultural producers registered as legal persons[15].

Naturally, given that, in their overwhelming majority, the subsoil users do not fall in the category of small producers with small environmental pollution payment bills, they come under the general rule concerning the procedure and deadlines for environmental pollution payments. What happens in reality?

For instance, after the end of the reporting quarter and before the 20th of the following month, the subsoil user makes the required environmental pollution payment on the basis of the generated emissions, discharges or placements of production- or consumption-related waste materials. We are discussing here a situation where the environmental pollution had been generated within the allowed thresholds and in line with the special permits issued by the competent government agencies.

Naturally, in cases where, during the reporting period, emergency releases had occurred (for example, emergency gas flaring), then the emergency-release volumes should be included in the overall quarterly obligatory payment amount and, where the discharges had exceeded the established thresholds, the payment rates should be increased tenfold. In principle, that matter is governed by the Tax Code and by other relevant RK legislative instruments and should not give rise to any disputes. In other words, the above described situation is a normal law-governed pro-

[15] See Article 463.2 and Article 463.6 of the RK Tax Code.

cedure established for the environmental pollution payments.

What has happened, though, in Tengizchevroil's own experience, for instance, shows that, in the case of emergency release, such gas flared, for example, to prevent the more serious environmental damage, local environmental protection bodies or other regulatory government agencies, within a matter of days, would hastily issue a demand to make an urgent payment for the emergency release. If the demand is not met immediately or if the amount assessed is disputed, that is promptly followed by a law suit filed against the company concerned.

Why is it then that the environmental protection agencies concerned insist on environmental pollution payment almost immediately after the fact of emission or release of pollutants? Why would they want to present claims or initiate legal action before the expiry of the established payment deadline, as is required under the provisions of the Tax Code and other RK legislative acts?

It would be quite a different matter if, following the reporting period, the subsoil user refuses to make the required environmental pollution payment after the established deadline or fails to pay the entire amount as required. Where that is the case, enforcement action by the relevant regulatory government agencies would be quite in order and would not be questioned by the business entity concerned.

And what about the role of the RK tax agencies, which are required by law to exercise supervision over the taxpayers and oversee the timely and full payment of their respective taxes and other obligations to the state? The RK Tax Code does not give the environmental protection bodies any powers to verify the timely and full payment of environmental pollution fees. The environmental protection agencies have other functions of their own to perform. So why do they substitute themselves for the government tax agencies in terms of overseeing compliance with the RK tax legislation requirements?

It would appear necessary to have clear lines drawn between the respective scope and powers of those two government agencies and start eliminating the wrongful practices, without basis in law or justification, of seeking to exact early environmental pollution payments, even though the payments themselves might refer to the over-the-threshold emissions. The RK tax legislation lays down specific procedures and deadlines regarding the obligatory environmental pollution payments and those procedures and deadlines are there for all to follow.

There is no need, without sufficient justification, to present demands or initiate legal action before the expiration of the established deadlines for making the obligatory payments to the government. All such actions should be governed by reasonableness and lawfulness.

It would be proper to recall here that, under the provisions of Article 465, RK Tax Code, "the taxpayers shall present, to the RK tax agencies at the location of the environmental pollution object, their estimated amounts of current payments and declarations", which have to have the preliminary endorsement of the relevant authorized territorial environmental protection agency[16]. Unfortunately, this clear-cut procedure is not always followed. The carriage is placed before the horse, so to speak. In other words, things are not being done the way they should.

A few words are due here regarding the practice of application of the respective provisions of Section 12 (Land Tax) and Chapter 81, RK Tax Code (Land Plot Use Payments). In that particular area there are issues, too, which, if resolved, could help promote positive experiences regarding the collection of land use payments.

For instance, pursuant to Article 338.1 of the RK Tax Code and on the basis of zoning plans made in accordance with the RK Land Legislation, the local legislative bodies (known as the "maslikhat") have the right to decrease or increase the respective land tax rates established under Articles 329, 330, 332, and 334 of the RK Tax Code. With 100% certainty, one can say there is not a single case of Kazakh local legislative body reducing the land tax rates, while facts have been established of some local maslikhat raising the land tax rates unlawfully.

In Atyrau Oblast in the past few years, Zhiloy District Maslikhat in particular has been very active in passing a number of resolutions to raise the land tax rates to the maximum allowed (by 50%). Those land tax rate hikes had been approved without concern for the legislative

[16] See sub-clauses 1, 2, and 5 of Article 465 of the RK Tax Code.

requirement that this should only be done on the basis of appropriate land zoning plans. The latest land tax rates hike, in the absence of the required zoning plans, was approved on the basis of Zhiloy District Maslikhat Resolution #5-5 of 14 April 2004 and subsequently overruled by the court following a legal challenge from Zhiloy District Prosecutor at Tengizchevroil's request.

It should be noted that "zoning" implies designating land plots in accordance with their expected purposes and conditions governing the use of land. Under the RK Land Code[17], local-level zoning is the responsibility of district executive government agencies following the approval of the respective zoning plans by the elected district government bodies.

From the viewpoint of practical implementation of the RK tax legislation in the sphere of land relationships, of some interest is a recent dispute in Atyrau Oblast involving the RK tax authorities and Tengizchevroil as the land user concerned. It proved to be a case of civilized conflict resolution in a court of law. Therefore, in citing this case here, I do not mean to throw accusations at the RK tax authorities, as they only stood their ground on the basis of their own interpretation of the provisions of the Republic of Kazakhstan Land Legislation and of RK tax laws.

This is what the dispute was essentially about. Pursuant to the Agreement on the Establishment of Easement[18] concerning land plots used in the conduct of petroleum operations, Tengizchevroil had some of the land plots within its License Area registered in its own name. It is important to note here that this was the first Easement Agreement made by subsoil users in Kazakhstan. I should mention, too, that, the positive experience of drafting, coordinating, approving, and concluding that Agreement has since become the theme of a special National Conference sponsored by the RK Land Resources Administration Agency.

In accordance with Articles 69.5 and 69.6 of the RK Land Code, that was a paid easement. When an easement is established on state-owned land plots, which are not allowed for full-scale utilization, payment for the easement is made to the local Treasury Department. Determining the adequate pay for the established easement proved to be a difficult thing to do, especially considering the absence in Kazakhstan of previous experience to rely upon. The particular difficulty was in that it was necessary to develop a logical and convincing system to assess the amount of payment to be made. One further thing that complicated the situation was that the land plots remained in the category of reserve lands. At the same time, the easement pay is neither a form of land tax nor lease payment. Rather, the easement pay amounts to a form of damage paid due to the difficulties and rights restrictions involved in the use of land plots burdened by an easement. With that consideration in mind, TCO proposed that the easement pay amount should be calculated using the base land tax rate proportionate to the soil productivity class[19] of a given land plot under easement and to establish an easement pay rate at 50% of the base land tax rate. That particular percentage ratio, of the base land tax rate to the easement pay amount, is rooted in the fact that the easement-burdened lands, rather than being offered under a temporary land lease right, are offered under the limited specified-purpose use right, without the removing the land from its owner.

After the Easement Agreement became effective, the RK tax authorities took the position that the rate used by the parties was a wrong rate and insisted that the full base land tax rate should be applied and, as a result, demanded additional payments to be made. The tax authorities issued a Formal Notice requiring that additional easement pay amount calculations should be submitted. The tax people based their position on the provisions of Article 445 of the RK Tax Code, which stipulate that land use payments are levied on the land granted by the state for temporary usage. Given that the land legislation provides for two types of easement, one with pay and the other without and given that the Easement Agreement signed by Tengizchevroil stipulated easement with pay, the tax authorities argued that the relationships under the Agreement fell under the scope of the RK tax regulations. Given that the pay rate under the Easement Agreement was below the rate established under the RK Tax Code, the tax agency demanded that the Company should make additional payments.

[17] See Articles 1, 8, 12, 14, 36, 43, 64, 84, 110, 149, and 163 of the RK Land Code.

[18] See Article 12.36, RK Land Code.

[19] Soil quality assessment provides comparison characteristics of land quality (expressed in points) based on the soil studies. It is required for the purposes of economic assessment of land, land inventory, land improvements, etc. (See the textbook "Soil Science", ed. I.S. Kaurichev, Doctor of Agriculture, Kolos Publishers, Moscow, 1975)

Our own position was that, under the provisions of Article 2 of the RK Tax Code, no one should be required to pay taxes or any other obligatory payments to the treasury unless such payments were directly stipulated by the RK tax laws.

It is our considered opinion that the pay for easement is not a matter for the RK tax legislation but is, rather, governed by the RK land legislation. The RK Tax Code makes no reference to easement as taxation object. According to the RK Tax Code[20], land tax is only levied on legal or physical persons, which use land plots as taxation objects under the right of:

- ownership;
- enjoyment (permanent use); or
- primary free temporary land use.

With regard to Article 445, RK Tax Code, its provisions apply to payments for the use of land offered by the state for the purpose of temporary paid land use, in other words, it concerns lands leased out by the government.

Consequently, the Easement Agreement, made by Tengizchevroil for the use of lands used to conduct its petroleum operations, cannot be an object of taxation under the provisions of the RK Tax Code.

The dispute was resolved when the Specialist Inter-district Economic Court for Atyrau Oblast ruled for Tengizchevroil. All in all, this amounts to establishing a positive legal precedent based on the provisions of the existing RK tax legislation and RK land laws. As such, it is likely to help promote greater use of the easement institution in land relationships involving the subsoil users.

Justice and the rule of law in the Republic of Kazakhstan will, to a great extent, depend on the correct application of the law and on the civilized ways of dispute settlement. □

[20] See Article 324 of the RK Tax Code.