Oil and Gas Tax Guide*

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Value Added Tax (VAT)

Oil, gas, and oil products sold on the Russian market are subject to value added tax at the rate of 18 percent. The amount payable to the budget is the difference between amounts of tax charged to the purchaser of the products and amounts of tax paid to suppliers for goods, works, and services that have been used for production requirements. Advances received in respect of future supplies of goods, works, and services are also taxable and must be included in the taxable base. On determining the results for the tax period in which the corresponding sale actually takes place, the amounts of previously paid advances are deductible from the total amount of tax in accordance with the Tax Code.

Exports

Operations involving the export of oil (including stable gas condensate) and natural gas to countries outside the CIS, including transportation and shipment, are subject to 0 percent VAT. VAT paid to suppliers of goods used for export is reimbursable.

In the case of oil and gas supplies to CIS countries, the "country of origin" principle applies, i.e., they are subject to standard taxation at the rate of 18 percent.

VAT paid to suppliers in respect of goods and materials (work and services), which are used in the production and sale of export goods, may be claimed as a deduction or reimbursed in accordance with the Tax Code. It must be noted that tax is reimbursable provided that the company in question maintains separate records of expenditures relating to export operations and those relating to operations carried out on the domestic market. Current legislation does not give an exact definition of separate records, and taxpayers therefore have the right to establish their own rules for the maintenance of separate records of expenditures in their accounting policies.

Imports

Imported oil products are taxable at the rate of 18 percent. At the same time, no VAT is levied in respect of the importation into the territory of the Russian Federation of oil, stable gas condensate, and natural gas from the territory of CIS countries.

Payment of VAT on Behalf of Foreign Legal Entities

Russian VAT legislation provides that when goods, works, and services are sold within the territory of the Russian Federation by foreign organizations not registered with the tax authorities, VAT must be paid by tax agents out of resources which are transferred to the foreign organizations. Tax agents are organizations and private entrepreneurs registered with the tax authorities that acquire goods, works and services, from foreign persons within the territory of the Russian Federation. Tax agents are obliged to calculate the amount of tax due, withhold it from the taxpayer and pay it to the budget regardless of whether or not they themselves carry out taxpayer obligations associated with the calculation and payment of tax. In this respect, the tax base is determined as the amount of income from the sale of goods, works and services, inclusive of tax. Amounts of tax actually paid to the budget by an organization as a tax agent are subsequently tax-deductible (reimbursable).

International Agreements on Indirect Taxes

Russia has ratified a number of agreements and protocols with CIS countries in relation to the levying of indirect taxes. The agreements with Kyrgyzstan, Azerbaijan, Kazakhstan, and Armenia establish reductions of or exemptions from indirect taxes.

Furthermore, as from July 1, 2001 Russia applies the "country of destination" principle to the calculation of value added tax in relation to all goods exported from the territory of the Russian Federation other than oil, stable gas condensate, and natural gas which are exported to CIS countries.

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Changes in Legislation in Connection with the Introduction of VAT Accounts

At the end of 2003 the government of the Russian Federation decided to make amendments to the VAT legislation. The most significant amendments concern the introduction of VAT bank accounts. According to the bill, organizations and private entrepreneurs will have to open at least one VAT account which will be used solely for VAT settlements. The offsetting and refund of amounts of input VAT is made directly, dependent on the occurrence of settlements, via the VAT account. The bill is designed to prevent illegal VAT reimbursements.

This bill has alarmed many companies, as the introduction of such accounts would result in the diversion of working capital as well as a number of other adverse consequences. The business community is currently in discussions with the government over the methods of the introduction and operation of the accounts. There is almost no doubt that such accounts will be introduced in mid-2004, but it is not clear how the system will operate.

Customs Duties

Customs duties are levied upon the exportation of oil, natural gas, and oil products. The amount of duty on crude oil is established by the government of the Russian Federation, with account taken of world oil prices.

Export-import operations are also subject to customs clearance fees, which are calculated as a percentage of the customs value of exported or imported goods and raw materials.

Other Corporate Taxes

The following corporate taxes are also in force within the territory of the Russian Federation in 2004:

- Unified social tax;
- Tax on the assets of enterprises;
- Advertising tax;
- Transport tax;
- Unified tax on imputed income (as a special tax regime);
- Other taxes and levies in accordance with the Tax Code of the Russian Federation.

Special Tax Regimes for the Oil and Gas Industry Production Sharing Agreements (PSAs) Basic Legislation Governing PSAs in Russia

Production Sharing Agreements (PSAs)

Basic Legislation Governing PSAs in Russia

The basic principles of the PSA tax regime are established in the PSA Law[1] and in Chapter 26.4 of the Tax Code of the Russian Federation – "The System of Taxation in the Context of the Performance of Production Sharing Agreements." The PSA Law regulates relations that arise in the process of the conclusion, performance, and termination of production sharing agreements and defines the legal conditions of such agreements. Chapter 26.4, for its part, establishes a special tax regime which is applicable in the context of the performance of agreements which have been concluded in accordance with the PSA Law and meet the following conditions:

- The agreements were concluded after an auction was held for the grant of the right to use subsurface resources on a basis other than production sharing, and the auction was declared void.
- In the context of the performance of agreements in which the production sharing procedure is applied, the state's share of the total volume of extracted production is not less than 32 percent of the total quantity of extracted production.
- The agreements provide for the state's share of profit production to be increased in the event that investment efficiency indicators improve for the investor during the performance of the agreement. Investment efficiency indicators are established in accordance with the conditions of the agreement.

[1] Federal Law No. 225-FZ of December 30, 1995 "Concerning Production Sharing Agreements."

Parties to PSAs

In accordance with the PSA Law, the parties to an agreement are the state on the one part, and one or more investors on the other. The state's interest is represented by the government of the Russian Federation and the executive body of the constituent entity of the Russian Federation within whose territory the site of subsurface resources provided for use is situated.

In accordance with current Russian legislation, investors may be legal entities (or associations of legal entities formed on the basis of a joint activity agreement and not possessing the status of a legal entity), which invest their own, borrowed or attracted resources in the exploration, prospecting and extraction of mineral raw materials and are users of subsurface resources under the terms of the agreement.

Conclusion of PSAs

According to the PSA Law, no more than 30 percent of reserves of commercial minerals explored and recorded on the state balance sheet may be granted on a production sharing basis in Russia. The list of sites of subsurface resources available for development on a production sharing basis is approved by federal law.

A PSA is concluded on the basis of a competitive tender or an auction. The winner is the bidder that offers the highest price for the right to conclude the agreement. The agreement must be concluded no later than one year from the day of the formation of a commission responsible for developing the conditions of use of subsurface resources. The commission prepares a draft agreement and conducts negotiations with the investor with respect to each site of subsurface resource use. The commission must be formed no later than six months from the day on which the results of the auction are announced.

Agreements are signed on behalf of the state by the government of the Russian Federation and the executive body of the relevant constituent entity of the Russian Federation upon completion of plans and approval of all the necessary conditions of the agreement that are not mandatory conditions of the auction.

Specific Aspects of Work Performance

For the purpose of supporting the interests of Russian companies which act as suppliers of goods, works and services for the purposes of PSAs, there are a number of legislative requirements applicable to investors with regard to the attraction of Russian legal entities for the performance of PSAs. In particular, an agreement must include the following provisions:

- The preferential right of Russian legal entities to participate in work under the agreement as contractors, suppliers or carriers, or in another capacity on the basis of contracts with investors.
- Citizens of the Russian Federation must account for no less than 80 percent of all employees, except in the initial phases of work or in the event that there are no workers or specialists available with Russian citizenship.
- The acquisition of equipment, technical devices and materials necessary for the geological study, extraction, transportation, and processing of commercial minerals is such that the proportion thereof which are of Russian origin is not less than 70 percent of the overall value of equipment, technical devices and materials acquired in each calendar year for the performance of work under the agreement and the cost of acquiring and using which is reimbursed to the investor through compensatory production. Technical equipment, devices and materials are deemed to be of Russian origin provided that they were manufactured by Russian legal entities or citizens of the Russian Federation within the territory of the Russian Federation from units, parts, structures and components not less than 50 percent of which in value terms were produced within the territory of the Russian Federation by Russian legal entities and/or citizens of the Russian Federation.
- Not less than 70 percent of technological equipment (in value terms) for the extraction, transportation and processing of commercial minerals in the context of the performance production sharing agreements must be of Russian origin.

Production Sharing Methods

Any PSA provides for extracted production to be divided between the state and the investor. The PSA Law envisages two methods of production sharing.

The first method (indirect sharing) provides for the division between the state and the investor of profit production, which is understood to mean production extracted under the agreement less

the portion of that production whose value equivalent is used to pay tax on the extraction of commercial minerals, and compensatory production. In this respect, the maximum level of compensatory production must not exceed 75 percent (or, in the case of extraction on the continental shelf, 90 percent) of the total volume of extracted production.

Where the second method of production sharing (direct sharing) is selected, the investor's share of extracted production may be up to 68 percent depending on geological, economic and value assessments of the site of subsurface resources, the technical project, and indicators in the feasibility study for the agreement. In this case, however, there is no division into profit production and compensatory production. All extracted production is shared, which considerably simplifies the sharing procedure since it excludes the need to determine the amount of expenditures that must be reimbursed to the investor out of compensatory production.

According to the PSA Law, an agreement may envisage only one method of production sharing. It is not possible to switch from one production sharing method to another, or to replace one production sharing method with another.

Taxes and Levies Under a PSA

Taxes and levies under a PSA are paid according to the chosen production sharing method.

If the indirect sharing method is chosen, whereby profit production is shared between the state and the investor and compensatory production is transferred to the investor, the following taxes and levies are payable:

- Value added tax;
- Tax on the profit of organizations;
- Unified social tax;
- Tax on the extraction of commercial minerals;
- Payments for the use of natural resources;
- The charge for negative impact on the environment;
- The charge for the use of bodies of water;
- State duty;
- Customs fees;
- Land tax;
- Excise duty.

The investor is exempted from the payment of regional and local taxes and levies by decision of the relevant legislative state body or representative local government body. Where normative legal acts of legislative state bodies and representative local government bodies do not provide for an investor to be exempted from the payment of regional and local taxes and levies, the investor will be reimbursed for expenditures on the payment of those taxes and levies by means of reducing accordingly the share of extracted production transferable to the state, insofar as the portion transferable to the relevant constituent entity of the Russian Federation is concerned, by a quantity equivalent to the amount of such taxes and levies actually paid.

Amounts of value added tax, unified social tax, payments for the use of natural resources, charges for the use of bodies of water, state duty, customs fees, land tax, and excise duty paid by an investor and amounts of charges for negative impact on the environment are reimbursable.

An investor does not pay tax on the assets of organizations in respect of fixed assets and intangible assets which are on the taxpayer's balance sheet and are used exclusively in carrying out activities envisaged by an agreement. In the event that such assets are used by an investor for purposes not associated with the performance of work under an agreement, they will be assessed the tax on assets of organizations according to the standard procedure.

An investor does not pay transport tax in relation to means of transport (with the exception of motor cars) owned by it which are used exclusively for the purposes of the agreement. If means of transport are used other than for the purposes of an agreement, transport tax will be payable according to the standard procedure.

In the context of the performance of agreements that envisage the sharing of extracted production without the allocation of a share of compensatory production (direct sharing), an investor must pay the following taxes and levies:

- Unified social tax;
- State duty;
- Customs levies;
- Value added tax;
- Charges for negative impact on the environment.

The investor is likewise exempted from the payment of regional and local taxes and levies by decision of the relevant legislative state body or representative local government body. Where normative legal acts of legislative state bodies and representative local government bodies do not provide for an investor to be exempted from the payment of regional and local taxes and levies, the investor will be reimbursed for expenditures on the payment of those taxes and levies by means of reducing accordingly the share of extracted production which is transferable to the state, insofar as the portion transferable to the relevant constituent entity of the Russian Federation is concerned, by a quantity equivalent to the amount of such taxes and levies actually paid.

Regardless of the chosen method of production sharing, goods (which are imported into the customs territory of the Russian Federation for the performance of work under an agreement envisaged by work programs and expense estimates approved according to the procedure established by the agreement) and production (produced in accordance with the conditions of an agreement) which are exported from the customs territory of the Russian Federation are exempt from customs duty.

In the event that, while an agreement is in force, there is a change in the tax rate of value added tax, that tax will be calculated and paid at the tax rate established in accordance with Chapter 21 of the Tax Code.

As far as profits tax is concerned, the rate effective as at the date of entry into force of the agreement is applicable for the entire period of validity of the agreement.

Payments for the Use of Subsurface Resources Under a PSA. The PSA Law envisages the payment of eight types of payments for the use of subsurface resources, the rate of which is established in each individual agreement:

1) One-time payments (bonuses) for the use of subsurface resources upon the occurrence of events specified in the agreement and the license;

2) The charge for geological information concerning subsurface resources;

3) Annual payments for an agreed area of water;

4) The fee for participation in a competitive tender (auction);

5) The fee for the issue of licenses;

6) Regular payments for the use of subsurface resources (rentals);

7) Compensation for expenses incurred by the state for exploration and prospecting for commercial minerals;

8) Compensation for damage which is caused as a result of the performance of work under a PSA to small indigenous communities of Russia in places of their traditional habitation and economic activity.

Profits Tax Under a PSA. Special considerations relating to the charging and payment of profits tax are established according to the method of production sharing.

Under the direct method of production sharing, the payment of profits tax is replaced by a portion of production, which is transferred to the state.

Under the indirect method of production sharing, income from the performance of an agreement is the value of profit production belonging to the investor in accordance with the conditions of the agreement and non-sale income as determined in accordance with the Tax Code of the Russian Federation.

The value of profit production is determined as the product of the volume of profit production and the price of extracted production established by the agreement. An exception to this is oil prices, which are determined according to a special procedure.

Expenses of a taxpayer should be taken to mean justified and documented expenses incurred by a taxpayer in the context of the performance of an agreement.

Justified expenses are taken to mean expenses incurred by the taxpayer in accordance with the work program and cost estimate approved by the management committee in accordance with the procedure envisaged by the agreement and non-sale expenses which are directly connected with the performance of the agreement.

Under the indirect method of production sharing, expenses of a taxpayer are subdivided into:

1) Expenses which are reimbursable out of compensatory production (reimbursable expenses);

2) Expenses which reduce the tax base for tax.

Reimbursable expenses are expenses incurred by a taxpayer in an accounting (tax) period for the purpose of performing work under an agreement in accordance with the work program and cost estimate. Not reimbursable are:

1) The following expenses incurred prior to the entry into force of an agreement:

- Expenses associated with the acquisition of a package of geological information for participation in an auction.
- Expenses associated with payment of the fee for participation in an auction for the right to use a site of subsurface resources on the basis of an agreement.

2) The following expenses incurred on or after the date of entry into force of an agreement:

- One-time payments for the use of subsurface resources upon the occurrence of particular events specified in the agreement.
- Tax on the extraction of commercial minerals.
- Payments (interest) on credit and loan resources received and commission payments thereon and other expenses associated with the receipt and use of loan resources for the financing of activities under the agreement.
- Expenses incurred by a taxpayer for research and/or development which are incurred in the form of allocations for the formation of the Russian Technological Development Fund and other sectoral and intersectoral funds for the financing of research and development work according to a list to be approved by the government of the Russian Federation in accordance with the "Federal Law Concerning Science and State Scientific and Technical Policy."
- Court costs and arbitration fees.
- Expenses in the form of fines, penalties and/or other sanctions for the violation of contractual or debt obligations which have been acknowledged by the debtor or are payable by the debtor on the basis of a court decision which has entered into legal force, and expenses for the payment of compensation for damage caused.
- Expenses in the form of shortages of tangible assets in production and in storage and at trade enterprises in the absence of guilty parties, and losses due to thefts where the guilty parties have not been established.

Reimbursable expenses, the composition of which is determined by the agreement, must be approved by the management committee in accordance with the procedure established by the agreement. The amount of reimbursable expenses is determined for each accounting (tax) period and must be reimbursed to the taxpayer out of compensatory production.

The following are included in the composition of reimbursable expenses:

- Expenses incurred by a taxpayer prior to the entry into force of an agreement, if the agreement has been concluded in relation to deposits of commercial minerals not previously developed and the expenses concerned were not previously recognized by the user of the site of subsurface resources for the purposes of calculating tax in accordance with Chapter 25 of the Tax Code.
- Expenses incurred by a taxpayer on or after the date of entry into force of an agreement and over the entire period of validity of the agreement (including expenses for the development of natural resources; expenses associated with the acquisition, erection, manufacture and delivery of amortizable assets and rendering them fit for use; expenses incurred in the form of allocations to the abandonment fund for the financing of abandonment work; expenses associated with the maintenance and operation of assets which were transferred to the tax payer by the state for use without consideration; and management expenses associated with the performance of an agreement).

It should be noted that reimbursable expenses must be reimbursed to a taxpayer in an amount not exceeding the maximum level of compensatory production. Compensatory production for an accounting (tax) period is computed by means of dividing the reimbursable amount of expenses of a taxpayer by the price of production, which is determined in accordance with the conditions of the agreement (except for oil prices, which are determined according to a special procedure). Reimbursable expenses that are not reimbursed in an accounting (tax) period should be included in the composition of reimbursable expenses for the following accounting (tax) period.

Profit earned by an investor from the sale of compensatory production is taxable according to the procedure established by Chapter 25 of the Tax Code, and is determined as receipts from the sale of compensatory production, reduced by the amount

of expenses associated with the sale of that production which are not included in the value of compensatory production, reduced by the value of the compensatory production.

Tax on the Extraction of Commercial Minerals Under a PSA. Tax on the extraction of commercial minerals is payable by investors operating under agreements which envisage indirect production sharing.

The tax base arising from the extraction of oil and gas condensate from oil and gas condensate deposits is determined as the quantity of extracted commercial minerals expressed in physical terms. The tax base arising from the extraction of gas and other commercial minerals is determined as the value of extracted commercial minerals. The tax base is determined separately for each agreement.

The tax rate applied in respect to the extraction of oil and gas condensate from oil and gas condensate deposits is 340 rubles per one metric ton. In this respect, that tax rate is applied with a coefficient which reflects the movement in world oil prices – Cp, which is determined by the taxpayer itself each month according to the formula:

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

where **P** is the average level of prices for Urals crude oil for the tax period in US dollars per one barrel; **R** is the average value for the tax period of the exchange rate of the US dollar to the Russian ruble (which is established by the Central Bank of the Russian Federation).

This tax rate is applied in relation to the extraction of oil and gas condensate from oil and gas condensate deposits with a coefficient of 0.5 until the maximum level of commercial extraction of oil and gas condensate, which may be established by the agreement, is reached. Where an agreement establishes a maximum level of commercial extraction of oil and gas condensate, once that maximum level has been reached the tax rate will be applied with a coefficient of 1, which will remain unchanged for the entire period of validity of the agreement.

The amount of tax on the extraction of commercial minerals upon the extraction of oil and gas condensate from oil and gas condensate deposits is calculated as the product of the relevant tax rate, calculated with account taken of the coefficient (Cp), and the amount of the tax base.

In the context of the performance of agreements, the tax rates, and specifically 17.5 percent for the extraction of gas condensate and 107 rubles per 1,000 cubic meters for the extraction of natural gas, are to be applied with a coefficient of 0.5.

VAT Under a PSA. In the context of the performance of agreements, VAT is payable according to the standard procedure. The tax rate which is current in the relevant tax period in accordance with Chapter 21 of the Tax Code – "VAT," is applicable. The following are exempt from taxation:

- The transfer without consideration of assets which are needed for the performance of work under a PSA between an investor and an operator in accordance with the work program and expense estimate which are approved in accordance with the established procedure.
- The transfer by an organization which is a member of an association without the status of a legal entity (investor) to other members of that association of a portion of the extracted production received by the investor under the conditions of the PSA.
- The transfer to the state of assets which were used for the performance of work under a PSA and are transferable to the state in accordance with the conditions of the agreement.

Customs Duties Under a PSA. Goods imported into the territory of the Russian Federation for the performance of work under an agreement envisaged by the work program and expense estimate and products produced in accordance with the conditions of an agreement, which are exported from the territory of the Russian Federation, are exempt from customs duties.

Payroll Contributions Under a PSA. This is an area in which the PSA Law does not grant investors any significant benefits on the basis of equality with other employers. □