Oil & Gas Tax Guide to Russia

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Introduction

Oil is of vital importance to Russia, being the main source of exports alongside other raw materials, and taxes paid by oil companies remain one of the principal sources of budget revenue. The Russian economy is heavily dependent on the price of oil, a trend which it has been impossible so far to overcome. Exports of energy sources – oil and gas – account for more than a third of the state's revenue. The Ministry of Economic Development and Trade of the Russian Federation recently reported that the high world prices for energy resources accounted for 5.4% of the overall growth in GDP, i.e., three quarters of the annual growth. Budget planning from one year to the next is performed with account taken of the price of oil.

Russia, which is not a member of OPEC, has moved to second place behind Saudi Arabia in terms of volumes of oil exportation and extraction. It is a key supplier of oil to a number of European countries, and in particular to Germany. Russia's oil industry is dominated by a number of vertically integrated oil companies. The current industry leader is LUKOIL, while second place was until recently occupied by YUKOS. Third place in terms of oil extraction is firmly held by TNK-BP, followed by Surgutneftegaz and Sibneft. The oil industry accounts for approximately half of all investments in the Russian economy.

According to data issued by the Ministry of Natural Resources of the Russian Federation, the quantity of Russian proven oil reserves currently varies between 60 billion and 130 billion barrels (from 8.2 billion to 17.8 billion tons). Russia accounts for 4.6% of the world's proven oil reserves. This figure is not huge, but it is important to take into account the fact that 77% of proven oil reserves are accounted for by countries within the world monopoly that is the OPEC cartel. As far as gas reserves are concerned, Russia holds second place with 30.7% of total world reserves.

Presented below is an illustration of the distribution of reserves of raw hydrocarbons.

Fig. 1. **Distribution of Reserves of Raw Hydrocarbons by Region of Russia**

In 2004 Russian oil companies extracted a total of 458.81 million metric tons of oil and gas condensate. According to the International Energy Agency, in the third quarter of last year Saudi Arabia extracted 8.29 million barrels a day, while Russia extracted 8.68 million barrels. Thus, the Russian Federation accounted for 10.97% of the world's total oil extraction. In 2004 Russian oil companies extracted as much oil as they had extracted over the last 12 years.

Table 1. **Oil Extraction by the Largest Vertically Integrated Oil Companies in 2003-2004, millions of metric tons***

Companies	2003	2004 (projected)
LUKOIL	78.7	85.6
YUKOS	80.8	89.2
Surgutneftegaz	53.9	57.6
TNK (TNK-BP)	42.9	80.8
Sibneft	31.4	38.8
Tatneft	24.7	24.6
Other companies	108.98	82.21
Total	**421.38**	**458.81**

*Source: company data.

Oil and gas companies are among the principal taxpayers in Russia. The tax burden on oil companies is on average higher than for other sectors, and this is mainly attributable to the high level of world oil prices. At the same time, according to statements made by the Ministry of Finance, the government has no plans to increase the tax burden on oil and gas companies.

Legal Aspects of the Activities of Oil and Gas Companies

BASIC LEGISLATION

At present, oil and gas companies 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 that 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. 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. 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 subsurface site 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, palaeontological and other geological samples.

Subsurface resources may be provided for use for more than one type of activity at once. The license certifies the right to use a specified subsurface site in accordance with an agreement that sets out all the significant conditions of use of subsurface resources. The provision of a subsurface site for use on the basis of a production sharing agreement is similarly formalized by a license to use subsurface resources.

THE LAW CONCERNING PRODUCTION SHARING AGREEMENTS

The "Law Concerning Production Sharing Agreements" (hereinafter referred to as "PSA Law") 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 to ensure stability in those relations.

A production sharing agreement (also referred to as "PSA") is an agreement in accordance with which the state grants an investor, on a repayable basis and for a specified period of time, exclusive rights to the exploration, prospecting and extraction of mineral raw materials on a specified site of subsurface resources. The investor, for its part, undertakes to carry out the work within the agreed timeframe, at its own expense and at its own risk.

The Parties to a PSA

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 is represented in a PSA by the government of the Russian Federation and the executive body of the constituent entity of the Russian Federation in whose territory the subsurface site that is granted for use is situated. In accordance with current Russian legislation, investors may be legal entities or associations of legal entities which are established on the basis of a joint activity agreement and do not have the status of a legal entity.

Methods of Production Sharing

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. Profit production is 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% (or, in the case of extraction on the continental shelf, 90%) of the total volume of extracted production.

Where the second method of production sharing (*direct sharing*) is selected, 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. The investor's share of extracted production may be up to 68% when this method is used.

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.

Specific Aspects of Work Performance

For the purpose of supporting the interests of Russian companies which act as suppliers of goods, work 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.
- Citizens of the Russian Federation must account for no less than 80% of all employees, except in the initial phases of work or in the event that there are no workers or specialists available who are Russian citizens.
- The acquisition of technological equipment, technical devices and materials necessary for the geological study, extraction, transportation, and processing of commercial minerals must be such that the proportion thereof which are of Russian origin is not less than 70% of the overall value of equipment, technical devices and materials which are 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.
- Not less than 70% of technological equipment (in value terms) for the extraction, transportation and processing of commercial minerals in the context of the performance of the conditions of an agreement must be of Russian origin.

In this respect, equipment, technical devices and materials are deemed to be of Russian origin provided that they were manufactured by Russian companies (individuals) within the territory of the Russian Federation from units, parts and components not less than 50% of which in value terms were produced by Russian legal entities and/or individuals in the territory of Russia.

PRINCIPAL TRENDS IN THE DEVELOPMENT OF LEGISLATION CONCERNING SUBSURFACE USE

There are numerous discussions in progress regarding the need for further development of the legislation concerning subsurface resources. It is obvious that the "Law Concerning Subsurface Resources," which was adopted more than 10 years ago, needs to be updated, as many issues which are of concern to subsurface users are not dealt with by that law. In view of these problems, a revised version of the "Law Concerning Subsurface Resources," which has been tabled for consideration in 2005, proposes amendments in the subsurface legislation involving:

- A broader use of civil-law relations.
- The demarcation of powers in the area of subsurface use between federal bodies and state bodies of constituent entities of the Russian Federation.
- Ensuring the continuity of the development of subsurface legislation.
- Clarifying the norms of existing legislation and introducing new norms governing the extraction of commercial minerals on the territory of the Russian Federation.

Taxation of Companies in the Oil and Gas Industry

COMPANIES ENGAGED IN THE EXTRACTION OF OIL AND GAS (LICENSE REGIME)

Russian companies which engage in the extraction of oil and gas pay the following taxes:

- Profits tax.
- Value added tax (VAT).
- Tax on the extraction of commercial minerals.
- Payments for the use of subsurface resources.
- Other corporate taxes.

Taxation of Russian Companies

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."

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. The procedure for the maintenance of tax records must be established by the taxpayer in its accounting policies for taxation purposes.

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

Items of income which make up taxable profit are divisible into income from the sale of goods (work and services) and non-sale income such as income in the form of interest received under loan agreements, income from the renting out of property, income in the form of assets received without consideration, income in the form of the value of surpluses of goods and materials and other assets which are discovered as a result of stock-taking, etc. Items of income which are not taken into account in determining the tax base include such items as income in the form of assets, property rights, work or services that have been received by way of a deposit to secure debt obligations, income in the form of assets received by a Russian

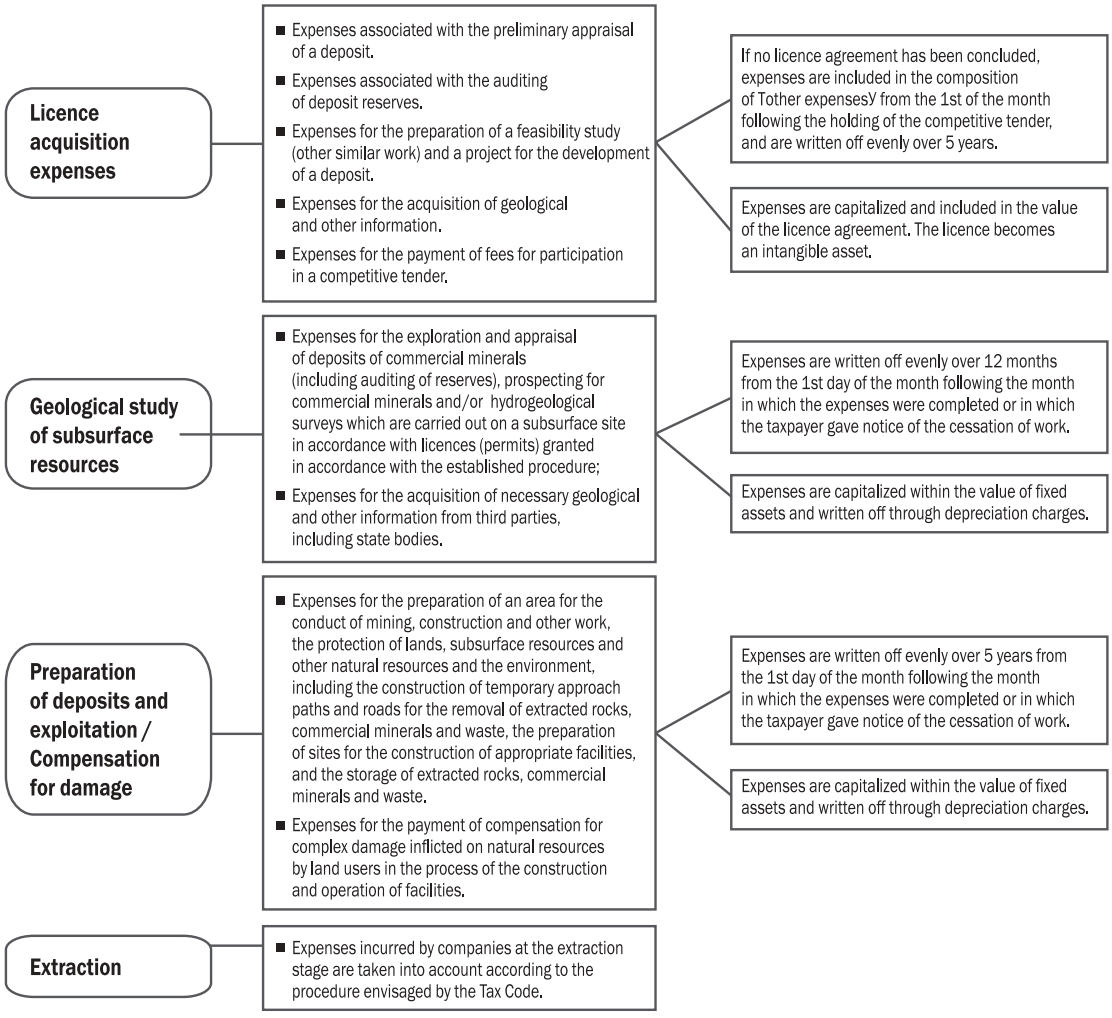
organization without consideration from another organization where more than 50% of the charter capital of the receiving party consists of a contribution of the transferring party, income in the form of amounts by which the charter capital was reduced in an accounting (tax) period, income in the form of a positive difference arising from the revaluation of precious stones in connection with changes in the reference prices for precious stones, etc.

In accordance with Chapter 25 of the Tax Code, all economically justified and documented expenditures are recognized as expenses. A number of types of expenses are subject to special regulations that establish particular conditions governing the determination of those expenses: these include expenses associated with the repair of fixed assets, research and development, the formation of doubtful debt reserves, the development of natural resources, et al. Since expenses associated with the development of natural resources are specific to the oil and gas sector, we shall examine in more detail the composition of those expenses and specific accounting procedures relating thereto.

Expenses Associated with the Development of Natural Resources

Chapter 25 of the Tax Code defines the main types of expenses associated with the development of natural resources and the conditions which must be met in order for those expenses to be taken into account for taxation purposes. Among the expenses identified by tax legislation are expenses associated with the acquisition of licenses, the geological study of the subsurface, prospecting for commercial minerals and the performance of preparatory work. Expenses associated with the extraction of hydrocarbons are subject to the normal conditions of accounting for expenses. This information is presented in greater detail in Chart No. 1.

Chart No. 1. **Expenses Associated with the Development of Natural Resources**



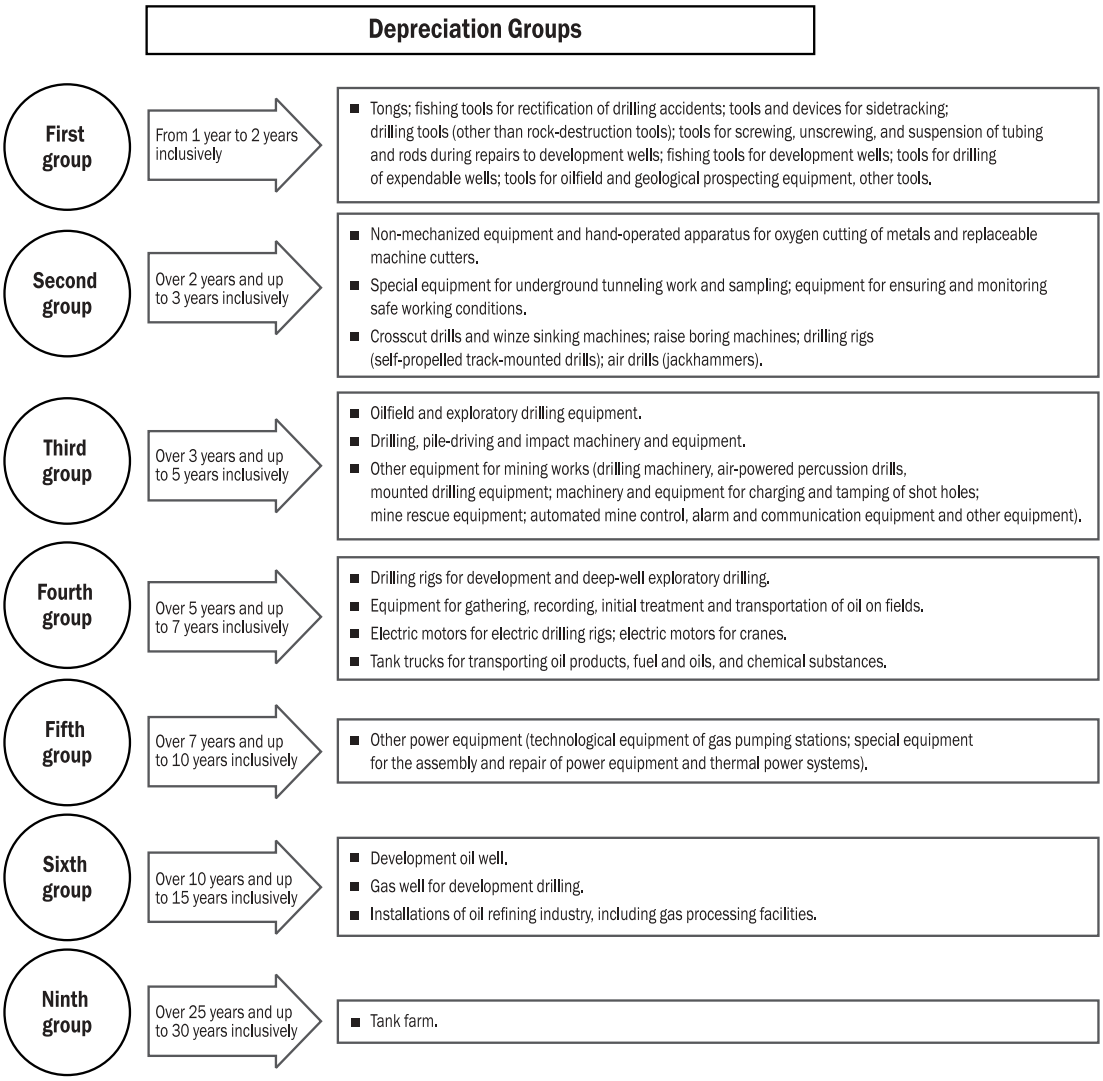
Amortization

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 RUB 10,000.

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 first group includes all short-life assets with a useful life of from one year 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 (see more detailed in formation in Chart No. 2). The useful life is determined by a taxpayer independently as at the date on which a particular item of amortizable assets is brought into use in accordance with the provisions of the relevant article and with account taken of the classification of fixed assets approved by the government. 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

Chart No. 2. **Inclusion of Certain Fixed Assets Used in the Oil and Gas Industry in Amortization Groups**



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 10.

Tax Rate

The rate of profits tax is established at 24% of the taxable base. Tax must be transferred to federal and regional budgets in proportions of 17.5% and 6.5% of the taxable base 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%. Thus, the minimum tax rate cannot be lower than 20%.

Special Considerations Relating to the Taxation of Foreign Organizations

Foreign legal entities which carry out entrepreneurial activities in Russia through a permanent establishment are liable to pay profits tax at the rate of 24% 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.
- 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 more than 50% of whose assets consist of immovable property situated within the territory of the Russian Federation, and of 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% on any income other than income from dividends and particular types of debt obligations.
- 10% 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% 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.

Value Added Tax (VAT)

The procedure for the calculation and payment of value added tax is regulated by Chapter 21 of the Tax Code of the Russian Federation – "Value Added Tax."

The object of taxation is the sale in the territory of the Russian Federation of goods, work and services and the importation of goods into the customs territory of the Russian Federation. The transfer of goods and performance of work and services for own requirements and the performance of construction and assembly work for own consumption is also subject to VAT.

The standard VAT rate of 18% is applicable in 2005.

Customs Payments

Customs payments are monetary charges levied by the state on goods, property and valuables when they are moved across the Russian border.

The Customs Code establishes the following types of customs payments:

- Import customs duty.
- Export customs duty.
- Value added tax levied upon the importation of goods into the customs territory of the Russian Federation.
- Excise duty levied upon the importation of goods into the customs territory of the Russian Federation.
- Customs fees.

The types of customs duty rates and the parameters of and procedure for establishing those rates are laid down in the "Law Concerning the Customs Tariff." The rates of import and export customs duties are set by the government of the Russian Federation. The rates of export customs duties for oil exports are established by the government of the Russian Federation for every two calendar months with account taken of movements in world prices for Urals oil. In the course of 2004 the export rates for oil increased more than threefold, from USD 31 per metric ton at the beginning of the year to USD 101 per metric ton at December 1, 2004. The customs duty rate in effect from February 1, 2005 is USD 83 per metric ton. The current rate of export customs duty for natural gas is 30% of customs value or € 30 per 1000 kilograms.

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

- On the basis of the selling prices 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 selling prices 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 duties, 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% of the taxable base. For gas condensate the rate of tax is 17.5%. For the period from January 1, 2002 until December 31, 2006 the legislation lays down transitional provisions according to which, from January 1, 2005 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 RUB 419 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 and 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, 2005, 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 – RUB 107 per 1,000 cubic meters.
- Associated gas (gas extracted via an oil well) – RUB 0.

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 subsurface site 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.

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 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% 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 subsurface users 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 of 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 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 context of production sharing agreements are established by the agreements within limits prescribed by the government of the Russian Federation.

Other Corporate Taxes

The following corporate taxes are also in effect in the territory of the Russian Federation in 2005:

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

PRODUCTION SHARING AGREEMENTS

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." 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% 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).

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

Tax Regime Under the Indirect Production Sharing Method

If the 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.
- The 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.

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 agreements. 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 to 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.

Tax Regime Under the Direct Production Sharing Method

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:

- The unified social tax.
- State duty.
- Customs fees.
- 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. There 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

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

equivalent to the amount of such taxes and levies actually paid.

Regardless of the chosen method of production sharing, an exemption from customs duty applies for 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 for production produced in accordance with the conditions of the agreement which is exported from the customs territory of the Russian Federation.

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 – "Value Added Tax."

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.

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:

- Expenses which are reimbursable out of compensatory production (reimbursable expenses).
- 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 taxpayer 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 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 period should be included in the composition of reimbursable expenses for the following accounting 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 that are not included in the value of compensatory production, reduced by the value of the compensatory production.

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 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.

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 RUB 340 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 and **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% for the extraction of gas condensate and RUB 107 per 1,000 cubic meters for the extraction of natural gas, are to be applied with a coefficient of 0.5.

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 and areas of the seabed.

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

5) The fee for the issuance 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.

Customs Duties Under a PSA

Goods which are 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.

TAXATION OF COMPANIES ENGAGED IN OIL AND GAS PROCESSING

Russian companies which engage in oil and gas processing pay the following taxes:

- Profits tax.
- Value added tax (VAT).
- Customs payments.
- Excise duties.
- Other corporate taxes.

Profits Tax

Income and expenses of oil refining companies are determined for profits tax purposes in the same way as for oil extraction companies. Oil refining companies use amortization, tax accounting and tax calculation methods similar to those used by extraction organizations.

Foreign companies engaged in the processing of oil and gas in the territory of the Russian Federation calculate profits tax in the same way as foreign companies which extract oil in Russia.

Value Added Tax

The procedure for the calculation and payment of value added tax is regulated by Chapter 21 of the Tax Code of the Russian Federation – "Value Added Tax."

The object of taxation is the sale in the territory of the Russian Federation of goods, work and services and the importation of goods into the customs territory of the Russian Federation. The transfer of goods and performance of work and services for own requirements and the performance of construction and assembly work for own consumption is also subject to VAT.

The standard VAT rate of 18% is applicable in 2005.

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, work and services that have been used for production requirements. Advances received in respect of future supplies of goods (work 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 products, like operations involving the export of oil and natural gas, are subject to 0% VAT.

Imports

Imported oil products are taxable at the rate of 18%. However, no VAT is levied in respect of the importation of oil products into the territory of the Russian Federation from the territory of CIS countries.

Customs Payments

Customs payments are payable by companies which import goods into the territory of the Russian Federation or export goods from the territory of the Russian Federation.

Customs payments include:

- Import customs duty.
- Export customs duty.
- Value added tax levied upon the importation of goods into the customs territory of the Russian Federation.
- Excise duty levied upon the importation of goods into the customs territory of the Russian Federation.
- Customs fees.

The size of customs payments is established in accordance with the Tax Code of the Russian Federation and government decrees.

Table 2. **Examples of Import and Export Duties for Certain Oil Products**

Oil products	Import duty	Export duty
Petrol	5% of customs value	USD 57 per 1000 kg
Fuel oil	5% of customs value	USD 45.4 per 1000 kg
Motor oils	5% of customs value	USD 57 US per 1000 kg

Processing Customs Regime

Oil refining companies may also use the "processing in the customs territory" regime, according to which oil is imported into the customs territory of the Russian Federation for processing and the subsequent exportation of oil products. In this case VAT and customs duties are not payable, but the customs authority has the right to demand security (a deposit or bank guarantee) for the payment of VAT and duty for the entire period of processing. The period of processing is determined by the declarant in consultation with the customs authority on the basis of the duration of processing procedures, and may not exceed two years. When the processed products are exported from the territory of Russia they are exempt from export customs duties, but are subject to 0% VAT as in the case of normal exports.

Excise Duties

In 2005 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 of oil products that have been independently produced from own raw materials by an organization which does not possess a relevant certificate to carry out operations involving oil products.
- 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 by an organization which does not possess a relevant certificate to carry out operations involving oil products.

! The receipt of oil products by an organization or private entrepreneur which possesses a certificate, including acquisition of ownership of oil products.

! The recording in accounts of oil products independently produced from own raw materials and other materials and received by way of payment for services involving the production thereof from customer-supplied raw materials and other materials.

! The receipt by the owner of oil products produced from own raw materials and other materials and received in payment for services involving the production thereof from customer-supplied raw materials and other materials on the basis of a processing agreement.

Table 3. **Certificates Are Issued Subject to the Following Requirements Being Met:**

Certificate	Conditions of granting of certificate
Production certificate	! Provided that the organization or private entrepreneur has ownership of facilities for the production, storage and supply of oil products.
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%).
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%)
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.

! The transfer by an organization or private entrepreneur of oil products produced from customer-supplied raw materials and other materials to the owner of those raw materials and other materials where that owner does not possess a certificate.

The Tax Code requires taxpayers which carry out a number of the above-mentioned operations to receive certificates of registration depending on the type of activity:

! Production of oil products – a production certificate.

! Wholesale sale of oil products – a wholesale sale certificate.

! Wholesale and retail sale of oil products – a wholesale and retail sale certificate.

! Retail sale of oil products – a retail sale certificate.

A certificate may be obtained not only by the organization which actually owns the relevant facilities, but also by an organization which owns more than 50% of the charter (pooled) capital of such an organization or more than 50% of the voting shares in such an organization.

Taxpayers have the right to deduct amounts of excise duty charged upon receipt of a certificate of registration of a person that carries out operations involving oil products, which is issued by the tax authorities. In particular, the following deductions may be made in relation to the sale of oil products:

! Amounts of excise duty charged upon the receipt of oil products by a taxpayer which possesses an appropriate certificate.

! 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.

! Amounts of excise duty paid by persons possessing a certificate when excisable oil products are imported into the customs territory of the Russian Federation.

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

Other Corporate Taxes

The following corporate taxes are also in effect in the territory of the Russian Federation in 2005:

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

Table 4. **The Rates of Excise Duties for Certain Types of Oil Products in 2005**

Types of oil products	Tax rates effective from January 1, 2005 (RUB / metric ton)
Petrol with an octane number of up to 80 inclusively	2,657
Petrol with other octane numbers	3,629
Diesel fuel	1,080
Oil for diesel and/or carburetor engines	2,951

TAXATION OF COMPANIES ENGAGED IN THE SALE OF OIL, GAS AND OIL PRODUCTS

Russian companies which engage in the sale of oil, gas and oil products pay the following taxes:

- Profits tax.
- Value added tax (VAT).
- Customs payments.
- Excise duties.
- Other taxes and levies.

Profits Tax

Income and expenses of companies engaged in the sale of oil, gas and oil products are determined for profits tax purposes in the same way as for extraction and processing companies. Such companies use amortization, tax calculation and tax accounting methods similar to those used by extraction and processing organizations. The rate of profits tax is 24%.

Value Added Tax

The procedure for the computation of value added tax by companies engaged in the sale of oil, gas and oil products is the same as for extraction and processing companies. The rate of tax for oil, gas and oil products is 18%. Operations involving the exportation of oil, gas and oil products are taxable at 0%.

Excise Duties

Oil products are included in the list of excisable goods in 2005. Gas, gas condensate and oil are not excisable goods. The procedure and conditions governing the taxation of excisable goods for enterprises engaged in the sale of oil, gas and oil products are the same as for processing enterprises in that sector.

Other Corporate Taxes

The following corporate taxes are also in effect in the territory of the Russian Federation in 2005:

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