

The Limits of Stabilization Rights Under Subsoil Use Contracts and the Effect of De-Stabilizing Clauses with Respect to Mandatory Payments

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Of great concern to most investors is legislative clarity and the ability to work within a stable legal atmosphere. This is particularly true of ventures that tie up the investor's return for ten or more years, such as subsoil use contracts for petroleum and other mining operations. Unfortunately, Kazakhstani law does not provide precise answers to many questions relating to the stabilization of applicable law and to contract stabilization clauses. This gives rise to many disputes between subsoil users and state authorities concerning the effect of later legislative amendments (including, for example, changes to the laws that govern licensing, labor, and ecological safety).

This article will consider questions that often arise in practice for energy producers: Do stabilization rights really work? Can they be applied when the customs fee rates change? We will consider these matters in relation to the following example.

A Subsoil Use Contract concluded in 1998 (the Contract) states that the fees for the customs clearance of crude oil must be paid in accordance with current legislation. Until July of 2003, the subsoil user paid customs fees at rates established by the Government's Decree No. 1479 dated 7 November 1995. These rates varied from 0.2 to 0.4% of the customs value of goods, depending on the customs clearance method. On June 10, 2003, the Government adopted a new law under Decree No. 669, which changed the fee calculation mechanism (Decree 669).

Under the current law, customs fees must be paid on a fixed rate of 50 Euro per main page of cargo customs declaration. The subsoil user complied with the new law and paid custom fees in accordance with Decree 669. However, the customs authorities demanded that the payments should be made in accordance with previous rates, which are based upon customs value of goods. The rea-

soning for their demand is based on the Contract's tax stability regime.

In this situation, we believe that the legal stability principle does not apply and the customs authorities' reasoning is specious. We believe that this scenario should be considered under the rubric of the following questions:

- ! What are legislative stability and contract stability?
- ! Is it possible to stabilize the amount of customs fees with reference to a date that preceded the customs clearance of goods?
- ! Does the amount of customs fees constitute a contractual condition?
- ! How does the application of new laws on customs fees depend on the increase or decrease of customs fees?

What is legislative stability and contract stability?

Under Kazakhstani law there is no broad principle of legislative stability. The Constitution,¹ Criminal Code,² and Law on Normative Acts³ all contain clauses that outlaw the retroactive application of legislation where it imposes new responsibilities or obligations on citizens. However, in cases where a new law softens or abolishes these responsibilities or obligations, it will be applied retroactively. Similar clauses are also set out in the Code on Administrative Violations.⁴ These apply not only to citizens, but also to legal entities. In the Civil Code, legislative stability is defined as "the lack of retroactive application of civil legal acts and applicability

¹ RK Constitution, Article 77.3

² RK Criminal Code, Article 5.

³ RK Law on Normative Legal Acts, dated March 24, 2004, Article 37.

⁴ RK Code on Administrative Violations, Article 6.

of new laws to civil relations that arise from new laws".⁵

With respect to contracts, the stability principle is characterized a bit differently. Contractual conditions remain in force when the applicable law changes, except in cases when the law expressly requires its application to relations that arise from existing agreements.⁶ Laws on "Subsoil and Subsoil Use" and "On Petroleum" have similar clauses on stability. These provide that "amendments and changes to legislation that worsen the subsoil user's (contractor's) conditions shall not apply to activities under contracts concluded prior to the introduction of such amendments and changes".

Under the Law on Investment, the Republic guarantees the stability of contracts concluded between investors and state authorities, except where amendments are made by the agreement of the parties.⁷

Exceptions to this rule include amendments to laws that regulate excise goods, national and ecological safety, healthcare and morality. In these cases, an amendment of the contract is necessary.⁸ The matters of subsoil contract tax are separately stabilized. In these cases, the tax regime is stabilized until the end of the contract term. The only exception to this rule is where the contracting parties amend their agreement in order to maintain the 'balance of economic interests' of the parties.⁹

Accordingly, under current laws there are no universal stability rules. As a general observation, the prevailing laws govern social relationships as and when they arise. The law provides for certain exceptions to this rule, allowing the regulation of "earlier" civil law relationships by "new" retro-

active legislation or by "old" stabilized legislation. In the latter event, the parties must solemnize this arrangement by contract. For example, the tax law stabilizes the terms and rates of taxation for subsoil users.¹⁰ If a law is not stabilized, then newly created relationships falling under that law will be governed by current legislation.

These exception cases notwithstanding, the general rule is that the laws applicable to a contract

are not to change. For subsoil use contracts, laws that worsen a subsoil user's position are not applicable to activities under those contracts. Taxation is similarly stabilized.

Is it possible to stabilize the amount of customs fees with reference to a date that preceded the customs clearance of goods?

Under the Law on Taxes which was in effect as of the date of the Contract:

*a tax regime established under subsoil use contracts [...] operates without changes until the end of the contract term, except for the cases when changes to the contract's tax regime are introduced by the agreement of the parties to the contract and do not result in a change to the primary economic interest ratio of Republic of Kazakhstan and subsoil users on contracts.*¹¹ [direct translation]

The tax regime includes the contractual tax provisions and tax laws in force as of the contract's effective date. However, until the Tax Code came into force, customs fees and payments did not fall under the meaning of the term "tax regime". The Law on Taxes provided that:

*tax legislation of the Republic of Kazakhstan consists of this Law, which establishes mandatory payments of a tax nature...and regulates taxation relationships in the Republic of Kazakhstan (except for issues of customs fees that are regulated by special legislation [...])*¹² [direct translation]

Accordingly, the Law on Taxes directly excluded customs fees from the authority of the tax legislation. In addition, those Articles of the Law on Taxes, which set out the full list of national and municipal taxes and fees, did not reference "customs fees".¹³ It follows that the tax laws (including Article 94-3 of the Law on Taxes) granting tax regime stability do not apply to the regulation of customs fee payments. This means that the calculation and payment of customs fees for the custom clearance of goods does not fall under a stabilized tax regime. Therefore, any assertion that customs fees are fixed under the stabilized tax regime of a subsoil use contract is not supported by law.

The Law on Customs in force at the Contract's effective date stated that:

except for the cases established [...] by legal acts of the Republic of Kazakhstan in force at the moment of accepting customs declarations and documents

⁵ Civil Code, Article 4.

⁶ Civil Code, Article 383.

⁷ RK Law: "On investments", dated January 8, 2003, Article 4.

⁸ RK Law: "On investments", dated January 8, 2003, Article 4, RK Law on Subsoil and subsoil use, Article 71.

⁹ Law on taxes, Article 94-3, Tax Code, Article 285.

¹⁰ Tax Code, Article 282.2, RK Law on Taxes, Article 94.

¹¹ Law on Taxes, Article 94-3.

¹² Law on Taxes, Article 1.

¹³ Law on Taxes, Articles 3 and 4. Customs fees for the first time were included into the list of other mandatory payments to the budget when the Tax Code of the Republic of Kazakhstan dated June 12, 2001 was adopted. (See Article 59 and 64.)

that are necessary for custom purposes, shall apply to the Custom Activities".¹⁴ [direct translation]

The current Customs Code contains similar conditions.¹⁵ Accordingly, the amounts of customs fees for custom clearance were not and are not subject to stabilization.

The Law on Customs stipulated only one situation when customs fee could be decided by contract. The exception relates to the importation of goods by subsoil users under an investment contract.¹⁶ The current Customs Code similarly sanctions the stabilization of certain customs rules only for customs fee exemptions and tariff preferences. The Customs Code also reads that:

privileges provided on the basis of contracts, which are concluded prior to the date of effect of this Code, in accordance with the Republic of Kazakhstan Law "On Custom activities", under the condition of their non application, remain in force until the date stipulated in those contracts.¹⁷ [direct translation]

The foregoing situations are not applicable to our hypothetical case, because they relate to customs privileges, which were not available to subsoil users at the time of the Contract.

In summary, the laws in force at the moment of export-import operation govern the payment of custom fees. Aside from privileges under investment contracts, neither the Law on Customs nor the Customs Code provides for exceptions from this rule. Therefore, there would appear to be no legal basis for stabilizing the customs rates to the effective date of a subsoil use contract.

Does the amount of a customs fee constitute a contractual condition?

Under the law, an agreement is defined as an arrangement between two or more persons concerning the establishment, amendment or cessation of *civil* rights and obligations.¹⁸ An agreement is concluded if the parties agree on all material terms of the contract.¹⁹ Under the contract stabilization principle, the conditions of a contract remain in force even after the amendment of applicable civil legislation. The only exception arises when the new law specifically states its retroactive application. Therefore, the above question is of capital importance.

In order to answer this question, it is necessary to understand that the civil law applies only to civil law relationships. According to the Civil Code:

Civil legislation shall not apply to property relations which are based on the administrative or any other power subordination of one party by the other, including tax and other budget relations, except for the cases provided for by legislative acts.²⁰ [direct translation]

Accordingly, civil law rules that stipulate the priority of a contract and other conditions are applicable only to the contract's civil law conditions. In other words, the civil law can only establish priority rights where the matter concerned falls under its jurisdiction and not under some other field of legislation.

Customs fees are 'obligatory payments to the budget' and rules governing the payment of the same are based on the administrative power of the State. In these cases, an exporter or importer of goods is subject to the administrative jurisdiction of State authorities who supervise customs dealings in accordance with the law. The payment of customs fees falls under public law and is not a civil law contract. This means that the amount and payment of customs fees cannot be a contractual condition. This is an imperative provision of law. Accordingly, any stability protections afforded under civil legislation do not apply to the consideration of customs payments. Even if a contract purports to set out customs payment rates, such provisions do not constitute contractual conditions.

In our example, the Contract states that the payment of custom fees must be made in the amount determined by legislation. Aside from the question of privileges, the customs law did not permit the fixing of custom fees by subsoil use contracts. Therefore, the prevailing customs rules (whether included into the Contract or not) apply and are paramount to any contractual terms purported to speak to the matter. This means that it is not possible to definitively assert that a subsoil user should pay fees on rates stated by contract. These rates must be in the amount prescribed by law.

Similar provisions in the current legislation support this view. The Tax Code states that the Government establishes custom fee rates.²¹ Furthermore, the Customs Code stipulates that "customs fee rates are established by the Government and

¹⁴ Law on Customs, Article 6.

¹⁵ Customs Code, Article 5.

¹⁶ See Law on Customs, clause 7 of Article 149 and RK Law "On foreign investments", dated December 27, 1994, Article 22.

¹⁷ Customs Code, Article 531.2.

¹⁸ Civil Code of the RK, Article 378.1.

¹⁹ Civil Code of the RK, Article 393.1.

²⁰ Civil Code of the RK, Article 1.

²¹ Tax Code, Article 515.

come into force after 30 calendar days of their official publication".²² This means that any changes to the administrative law will affect a contract falling under its sphere, irrespective of whether the contract provides otherwise.

How does the application of new laws on customs fees depend on the increase or decrease of customs fees?

Notwithstanding the foregoing, the answer to the above question will be different depending on whether custom fees are increased or decreased.

Subsoil use and investment legislation protects subsoil-users and investors from the application of new laws that worsen their position under their contracts. In the case of an increase of customs fees, the subsoil user would continue making payments in the amounts established under the old legislation. But what happens if the new law decreases the customs fees?

Under the Law "On Foreign Investments" (which applies to contracts concluded prior to 2003), the parties could change the contract with an aim of achieving a balance of interests.²³ The tax legislation has similar provisions on the 'correction' of taxation terms under subsoil use contracts, in order to maintain the balance of economic interests.²⁴ Therefore, many subsoil use contracts

were changed after the decrease of the tax rates. However, there are strong arguments that a decrease of customs fees automatically

applies to the subsoil use contracts without the need to amend the same (at least those contracts concluded before the enactment of the Tax Code).

First, customs fees do not form part of a stabilized contractual tax regime. Second, the terms governing the payment of customs fees are not contractual conditions. As such, their inclusion into the contract does not mean that parties have agreed to the payment of customs fees in such amounts. Finally, customs legislation always stipulates that customs fees should be paid on prevailing rates.

Conclusion

Not all of the provisions in a subsoil use contract are contractual conditions enjoying stability. In order to determine whether a particular condition in a contract is stabilized, one must examine whether that condition falls under civil law or administrative law.

Customs legislation applying to subsoil use contracts concluded prior to the enactment of the Tax Code does not stabilize customs fee rates. Nor does this legislation require the amendment of the contract in order to maintain the economic interests of the parties. As a general rule, customs fees are paid at rates established by the prevailing legislation. When custom fees are decreased, the subsoil user pays the decreased amounts. When custom fees are increased, the subsoil user pays the old, lower amount, because it is stabilized against legislative changes that worsen its position. □

²² Customs Code, Article 292.2.

²³ RK Law "On foreign investments", dated December 27, 1994, Article 6.

²⁴ Law on Taxes, Article 94-3 and Tax Code, Article 285.