# Tax Specifics of Companies in the Oil and Gas Sector Operating on the Caspian Sea Shelf

*By Alexander Smirnov, Ernst & Young*

The Caspian Sea shelf is a unique natural region with a high concentration of natural hydrocarbon resources. Many oil companies are thus endeavouring to take part in the development of the Caspian Sea's natural reserves. Their operations are not always confined within the borders of a single state, and situations may arise in which one company works deposits belonging to several countries. This endeavour, however, runs up against problems of a political and economic nature. One such problem is the significant variation in tax law between countries in the Caspian region. Before proceeding, I should note that this article will not analyse problems involved in determining the Caspian Sea's status, and references to borders or territorial zones of states in the Caspian region will thus be of a provisional nature.

## Tax Specifics of Companies in the Russian Oil and Gas Sector

The main statutory acts governing the operations of oil and gas companies in Russia and the principles of their taxation are the Tax Code and the Law "Concerning Subsurface Resources". Companies in the oil and gas sector in the Russian Federation operate under the general tax regime or the regime of production sharing agreements (hereinafter, "PSA").

The principle taxes that apply in the territory of the Russian Federation are:

! ax on the profits of organizations (24%)

! value added tax (18%)

! tax on the assets of enterprises (up to 2.2%)

! unified social tax (regressive rate between 35.6% and 2%), etc.

In addition to these general taxes, users of subsurface resources in Russia are required to pay:

! mineral extraction tax at rates depending on the type of mineral extracted (16.5% for oil, 17.5% for gas condensate, 107 roubles per 1,000 cubic metres of natural gas; until December 31, 2006 transitional provisions apply to oil (347 roubles per tonne in 2004))

! the levy for participation in a tender (auction) and for a licence to use commercial minerals

The principles of the PSA tax regime are established in the law on PSAs (Federal Law No. 225-FZ of December 30, 1995 "Concerning Production Sharing Agreements") and the Tax Code (Chapter 26.4 "The System of Taxation in the Context of Production Sharing Agreements"). Taxes and levies under a PSA are paid in dependence on the chosen method of production sharing.

When the method selected involves the sharing of profitable production between the state and the investor and the transfer of compensatory production to the investor, the following taxes and levies are paid:

! value added tax;

! tax on the profits of organizations;

! unified social tax;

! mineral extraction tax;

! payments for the use of natural resources;

! payment for adverse impact on the environment;

! payment for the use of bodies of water;

! state duty;

! customs levies;

! land tax;

! excise duty.

Under agreements involving the sharing of all production without allocating a share of compensa-

tory production, the investor is required to pay the following taxes and levies:

- unified social tax;
- state duty;
- customs levies;
- value added tax;
- payment for adverse impact on the environment.

The specifics involved in calculating and paying profits tax are established in dependence on the method of production sharing. In the case of direct production sharing, a portion of production is transferred to the state in place of profits tax. In the case of indirect production sharing, the value of profitable production owned by the investor under the terms of the agreement and non-sales income determined in accordance with the Tax Code are recognized as income from the agreement.

## Tax Specifics of Companies in the Oil and Gas Sector in the Republic of Kazakhstan

The main laws governing the taxation of companies extracting commercial minerals in the Republic of Kazakhstan are the Tax Code, the Presidential Edict "Concerning the Use of Subsurface Resources" and the Presidential Edict "Concerning Oil".

Users of subsurface resources in Kazakhstan are required to conclude an agreement with the government of the republic or on general terms involving payment of excess profits tax (Model 1) or on the basis of the PSA regime (Model 2).

The principle taxes in Kazakhstan are:

- tax on the income of legal entities (30% on taxable income, allowing for certain deductions);
- VAT (tax rate of 15% since January 1, 2004);
- assets tax;
- land tax;
- excise duties on oil and other commercial minerals;
- tax on users of motor vehicles;
- royalties and payments for the right to use and develop deposits (from 2% to 6%, depending on the type of mineral), etc.

The amount of royalties varies, depending on the quantity extracted, between 2% and 6%.

Under the Tax Code, payments for the development of commercial minerals amount to 0.1% of the estimated value of extracted reserves.

In addition to the taxes and levies listed above, investors not utilizing the PSA regime and enjoying better than 20% profitability are required to pay excess profits tax on a progressive scale at a rate of between 15% and 60%.

If the PSA regime is utilized (Model 2), an investor is exempted from:

- payments for exporting crude oil;
- excise duty on oil and other natural resources;
- excess profits tax;
- land tax;
- assets tax.

Amendments to the Tax Code which came into force on January 1, 2004 deprive the government of the ability to amend existing agreements in the event of changes in tax law. The same applies to agreements that will be signed in future.

## Tax Specifics of Companies in the Oil and Gas Sector in the Republic of Turkmenistan

The main document governing the extraction of commercial minerals by foreign investors in Turkmenistan is the Law of the Republic of Turkmenistan "Concerning Hydrocarbon Resources".

The principle taxes in Turkmenistan are:

- profits tax (25%);
- VAT (20%);
- tax on users of subsurface resources (22% for gas and 10% for oil);
- assets tax (1%);
- payments to social funds, etc.

Foreign investors extracting oil and gas may conclude PSAs and conduct operations involving the extraction of hydrocarbons by concluding agreements for joint operations with the state.

Under the law, parties to PSAs are payers only of profits tax and contributions to social funds. Payment for the use of subsurface resources and additional payments are determined by agreement with the state. Payment for the use of subsurface resources is mandatory and varies between 2% and 15%. Additional payments are not man-

datory but are usually stipulated in the terms of a PSA and break down into two groups:

! payments due within 30 days after the agreement's entry into force;

! payments due when the parties to a PSA or participants in joint operations achieve a certain level of production.

The overall tax level may not exceed the level established as of the agreement's date of signing.

## Tax Specifics of Companies in the Oil and Gas Sector in the Islamic Republic of Iran

The tax system in Iran is governed by the "Direct Taxation Act". The principle taxes in Iran are profits tax, import duties, assets tax and withholding tax.

Iran has no value added tax. A draft law to introduce VAT was prepared in 1990 but has not yet been considered by parliament.

Iran's principle tax is profits tax (25%). Branches of foreign legal entities pay profits tax on a tax base calculated as the company's aggregate income multiplied by a set coefficient (12%). The tax rate is 25%.

The law envisages a number of exemptions for foreign companies. For example, foreign contractors may be exempted from import duties on temporary imports of equipment, taking into account certain specifics, e.g., the means of depositing money for the period during which the temporary import regime is in effect.

At the same time, serious internal restrictions are placed on foreign investors. Foreign entities may own immovable property for commercial purposes as well as for personal residence. The assets tax rate may vary between 0% and 8%, depending on the value of the assets.

In view of the fact that Iranian law prohibits foreign companies from owning hydrocarbon concessions, companies involved in the extraction of oil and gas may operate in Iran under only one regime. A buy-back formula was developed in 1990 for the purposes of developing oil and gas deposits, Under this scheme, foreign companies conclude a contract with the National Iranian Oil Company and open branches in Iran. Foreign oil companies work deposits and receive compensation for expenses as well as a fixed amount of reimbursement, usually in the form of extracted oil. Buy-back contracts usually provide compensation for corporate taxes, social payments or other taxes and levies established by the Islamic Republic of Iran.

## Tax Specifics of Companies in the Oil and Gas Sector in the Republic of Azerbaijan

As of the present time, no laws specially regulating oil and gas production have been adopted in Azerbaijan. A draft law "Concerning Oil and Gas" was submitted to parliament some time ago, but it is still unclear when it will be considered by parliament. Provisionally, we can say that operations in the area of oil and gas production are governed by the provisions of law under two main regimes – the general tax regime and the PSA regime.

It should additionally be noted that two other special tax regimes are provided for under the Law "Concerning the Main Export Pipeline" (Azerbaijan – Georgia (Sea Terminal) – Turkey) and the Law of the Republic of Azerbaijan of October 26, 2001 in regard to the South Caucasus Pipeline (Azerbaijan – Turkey). These regimes provide a number of exemptions for investors, but I will not go into further detail here.

The principal taxes under the general tax regime are:

! tax on the profits of enterprises (24%);

! VAT (18%);

! other taxes and levies (withholding tax, payments to the social fund, assets tax, road tax, land tax, resource payments and other local taxes and levies as well as personal income tax).

Oil companies also pay excise duties and licence payments (royalties). Excise duty on hydrocarbon material extracted in the territory of Azerbaijan, including the Caspian Sea shelf in the Azerbaijani zone, may amount to between 1.7% and 144.92% of cost. Tax on the extraction of mineral raw materials (royalties) is between 3% and 26% of the wholesale price, depending on the type of raw material extracted.

In Azerbaijan, oil and gas consortiums engaged in offshore production generally operate under the PSA regime. Under the terms of a PSA, contractors pay profits tax and social contributions for local employees. The rate of profits tax for parties to a PSA may vary between 25% and 32%, depending on the specific agreement. Social pay-

ments amount to 27% for employers and 2% for employees and are withheld by the employer.

Moreover, additional payments and payments relating to the site where operations are conducted, which depend on the terms of the PSA, are significant. The parties to a PSA are exempted from all other taxes.

## International Tax Specifics of States in the Caspian Region

The majority of Caspian states have concluded bilateral double tax treaties with one another, establishing the principles and procedures involved in taxing residents of one state (legal entities or physical persons) that operate on the territory of another state. This forms a second group of issues, relating to the taxation of companies working on the Caspian Sea shelf.

The Russian Federation currently has double tax treaties with Kazakhstan, Azerbaijan, Turkmenistan and the Islamic Republic of Iran.

All such agreements contain similar provisions on the tax status of organizations qualifying as "permanent establishments". Recall that a permanent establishment has no legal or organizational significance and refers to a place of business through which a company in one treaty state conducts entrepreneurial activities wholly or partially in another treaty state. In this connection, it should be noted that a permanent establishment maintained for preparatory and auxiliary purposes on behalf of its head office is not recognized as a permanent establishment.

It should also be borne in mind that a mine, oil or gas well, quarry or any other place where commercial minerals are extracted gives rise to a permanent establishment. If a permanent establishment is formed, the company will be liable for all taxes – ncluding profits tax – in the country in which the establishment is located.

Double tax treaties also govern the procedure for applying income tax to such types of income as interest and dividends.

It is evident from this analysis that a number of tax law specifics may significantly affect the establishment and development of business by any company that is a resident of one state and wishes to conduct commercial activities in another state. A further point of some significance is that the tax law of states in the Caspian region is undergoing constant change. Timely and highly competent tax planning is thus an essential element in the preparation of commercial operations and projects. ☐