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Tightening of the subsoil user tax legislation: the main stages of development

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Dear Ladies and Gentlemen,

We are sending you a piece of significant information that we hope might be extremely beneficial to your company.

At the present time, the government subsoil users tax policy is one of the most important issues for subsoil users. The export duty, discussions as to the severance tax levy and the new draft of transfer pricing demonstrate the urgency and importance of analysis of the government tax policy and the possible consequences of its implementation for subsoil users.

It should be made clear that the author of this article, Almat Daumov, a Partner at GRATA Law Firm and the Director of Tax Department, is conducting a detailed analysis of the changes in the government taxation policy applied to subsoil users by considering the changes and developments in this field of tax legislation

The following main stages of tax legislation development in relation to subsoil users may be summarised as the following:

1. 1991-1995- all tax conditions were determined by **mining contracts;**
2. 1995-2004 - adopted Tax Law and Kazakhstan Tax code consolidated basic terms and conditions of mineral resources users taxation (principle of tax regime stability etc.);
3. 2004-2008 - tightening of tax legislation (rental tax levy, cancellation of principle of tax regime stability etc.);
4. 2008 and in the future - export duty and the enactment of new Tax code and Transfer pricing law.

The first stage can be characterized in a basic form as a partnership between subsoil user (investors) and the state. In other words, all basic taxation conditions of subsoil users contract activity were stipulated in the mining contracts. The Republic of Kazakhstan signed the first production sharing agreements and major mineral deposit mining contracts. At the same time, the state provided basic tax regime stability regarding mining contracts. For this reason the state took into consideration relationship patterns, proposed by subsoil users, including tax regime models for the use of mineral resources. The actual tax legislation was obsolete and did not comply with the real economic situation that showed the necessity of the attraction of foreign capital into the economy of Kazakhstan.

The second stage was notable for the first Kazakhstan Tax Law **–** the Decree of the President of the Republic of Kazakhstan; dated 24/04/95 "**On Taxes and Other Mandatory Payments to the Budget"** (further "The 1995 Tax Law"). At the end of 1996 the Tax law was supplemented with provisions of tax treatment stability. The 1995 Tax law implemented the foundations of subsoil users' taxation, the scope and reach of subsoil users special payments and taxes and the procedure for its calculation and payment were revealed.

At the end of 1996 the Tax law was supplemented with provisions of tax treatment stability:

Article 94-3. Tax treatment stability

1. The tax regime, specified in the mining contract, in the established form and after undergoing a mandatory tax evaluation, will be enforced until the end of the validity period of this contract, except for special provisions provided in clause 2 of the given article.

2. In the event that there is a change in legislation after the date of contract subscription that makes it impossible to keep to the original terms of the agreement or leads to major changes to its general economic terms, the subsoil user and representative of the authorized tax body can introduce the necessary amendments and additions to the contract for the restoration of the parties' economic interests that were included at the moment of its signing. These amendments or additions can be introduced for sixty days from the moment of Tax body or subsoil user sends written notification.

In other words the tax regime, implemented by a mining contract, is stable, except for alterations and amendments submitted to the contract based **on the parties agreement**. It states that clause 2 of the given article is based on discretion – the parties **can** introduce amendments or additions into the contract.

The first codified normative legal act devoted to questions on taxation – Tax Code RK dated 12 June 2001"**On Taxes and Other Mandatory Payments to the Budget"** (further "Tax Code") was enacted in 2001. It implemented the general provisions of tax law with regards to subsoil users' taxation and detailed some clauses. The Provisions on stability of the tax regime, in fact, are the same:

Article 282. Establishment of Tax Regime for Mining Contracts.

1. Tax regime for subsoil user shall be determined in compliance with the mining contract concluded in the order determined by the Government of the Republic of Kazakhstan.

2. Tax regime, determined in the contract, shall satisfy the tax legislation provisions, that regulate tax and other mandatory payments into the budget by *individuals and* legal entities enforced on a day of contract subscription.

Article 285. Conditions of Taxation in the Event of Change in Tax Legislation.

1. Adjustments may be made to the conditions of taxation specified in mining contracts in connection with a change in the tax legislation, by agreement between the parties.

In the event that there is an improvement in the conditions of taxation for a subsoil user resulting from changes in the tax legislation, an adjustment shall be made to the conditions of taxation in mining contracts with a view to restoring the economic interests of the Republic of Kazakhstan.

2. In the event that certain types of taxes and other mandatory payments to the budget provided for in a contract are repealed, the subsoil user shall continue to pay them to the budget following the procedure and in the amounts established under the contract, until such time as the relevant changes are made in the contract, following the procedure specified under item 1 of this article.

Clause 2 Article 282 of Tax Code provided the requirement in accordance with the tax regime, determined in the contract, to tax legislation enforced on the day of signing the contract. In this case the Government tightened the negotiation rules and restricted the interests of mining contract parties to tax legislation. For example, the corporate income tax rate determined by a mining contract shall satisfy the rate established by the Tax Code. At the same time, some negligible contradictions could be observed between tax provisions in mining contracts and tax legislation enforced on the date of signing the contract. In these cases the Tax authority repeatedly tried to prove the priority of the Tax legislation. However, Kazakhstan courts declared that the substance and immutability of tax regime, and the arguments of the tax body were not taken into consideration as the lack of contradictions between tax provisions in mining contracts and tax

legislation was proved by a tax evaluation. Furthermore, the contract works without amendments and conditions as this was not disputed by the parties and the relevant changes were not made.

In the event that there is a change in the tax legislation, the Tax Code implemented an adjustment to the mining contract by agreement between the parties. At the same time, the Government implemented a protection mechanism of its economic interests in case of changes in tax legislation related to any reduction of subsoil user taxation. The subsoil user shall continue to pay taxes (including repealed taxes) following the procedure and in the amounts (even if they were reduced) which were established under the contract until such time as the relevant changes are made in the contract. The admissions and additions into contract shall be submitted in accordance with the restoration of the economic interests of the Republic of Kazakhstan. For example, an increase in the royalty tax exchange for reduction in value - added tax 15%.

At the beginning of 2001 there was established the first legal act on transfer pricing – the Law of the Republic of Kazakhstan dated 5 January 2001 "On government control when transfer prices are used". The government provided price controls on crude oil and oil products, gas, non-ferrous and precious metals, irons, cotton, sugar etc. export for loss prevention of government income in international transactions. The subsoil users actively opposed the government price controls on export transactions, referring to the tax regime stability. However the Kazakhstan court refused to refer this case to the tax regime and stability alteration and accepted the competence of the tax body in price controls relating this case to a question of tax administration.

So, the second stage can be characterized as a stage when government and investors are equal in rights, and when not only investors but government economic interests are considered.

The third stage of subsoil users tax legislation development was notable for the enactment of the Law RK dated 29.11.2003 " On the Introduction of Changes and Amendments into Some Legislative Acts of the Republic of Kazakhstan on the Questions of Taxation". The main purpose of this law was to introduce accuracy and clarity in some provisions of the Tax Code on the calculation procedure of subsoil users taxes and special payments. Besides, these entire changes and amendments substantively increased the subsoil users' tax burden. If previously the royalties in mining contracts, according to Tax Code, was to be determined at the rate at not less than 0,5 % in accordance with the calculation basis, then after the introduction of the law there was provided an increased scale from 2 to 6 %. The excess profit tax scale was increased from 0-30 % to 15-60 %.

From 2004 Rental tax on crude oil at the rate of 1 to 33 % according to the market price per barrel was also introduced by this law.
According to the changes and amendments in mining contracts, except for production sharing contracts, the tax calculation is made **under the legislation in force at the moment of acceptance in payment liability, in other words the principle of tax regime stability was repealed**. At the same time the Government kept the stability of the mining contracts, which were concluded earlier **(before 1 January 2004)** and accepts the immutability of its tax regime. All mining contracts concluded after 1 January 2004 are not provided with tax regime stability.

Law enforcement practice of this period also confirms the tightening of the tax regulations. Increased practice of carrying out tax audits on excess profits tax, absurd crediting additional amounts of VAT to royalties and many other facts distinctly demonstrate the tightening of the tax regulations. For example, in the middle of 2005 the Kazakhstan tax authorities fundamentally changed the calculation procedure of the tax basis for excess profits tax from net income, which had been used for 9-10 years. The tax authorities revealed the imperfection of the applicable tax

legislation, as a conflict rule of Tax Law, Instruction #41 and Annual order on confirmation of rules for excess profit tax return. Considering their own normative legal acts conflicted with the Tax Law, the tax authorities credited additional sums of excess profit tax. Although in this clear cut case subsoil users carefully followed the instructions and orders of the tax authorities.

In 2005- 2006 the tax authorities carried out a number of blanket audits of major Kazakhstan subsoil users, and as a result the deduction of subsoil users' expenses on crude oil prices hedging for income tax calculation was called into question. This generally accepted financial instrument is a compulsory condition for the attraction of foreign investments, and seen as necessary for carrying-out a workable program, was labeled as an instrument not related to business. But the Kazakhstan courts accepted the subsoil users arguments and qualified such expenses as an expenditure related to business and contract subsoil user work.

Henceforth, the third stage is remarkable for a clearly defined tendency to the strengthening and tightening of subsoil users' tax regulations. The beginning of **the fourth stage** that we designated as commencing in 2008 was notable for some changes in legislation: specifically the implementation of customs duty for crude oil export, enactment of new Tax Code that provides increased tax burden on resource sector and a new transfer pricing draft law.

In most cases at the mining contract conclusion subsoil users reinsured themselves from import duty tax on foreign equipment necessary for new mine workings and development. For that reason the mining contracts usually agree to the inapplicability of import duty for equipment, and provide for the unimpeded and duty-free import of such materials and equipment to Kazakhstan. The custom duty for crude oil export levy could not be foreseen by anybody, as investors used to think that export is encouraged in all countries, that is why there would not be any problem with it.

On 15 October 2005 the Government enacted the Decree # 1036 "On Collection of Custom Duty when the Commodities made from Crude Oil are Exported from the Custom Territory of the Republic of Kazakhstan" (further "Decree #1036"). The first wording of Decree # 1036 did not provide for any custom duty for crude oil export.

On 8 April 2008 the Government of the Republic of Kazakhstan enacted the Decree #328 "On Introduction of Changes and Amendments into Decree of the Government of the Republic of Kazakhstan #1036 dated 15.10.2005" (further "Decree # 328"). To stabilize the internal crude oil market they introduced the following amendments:

1. Payment of custom duty on crude oil export (besides oil products);
2. Duty rates supplemented with rates on crude oil export;
3. Calculation scales on rates of custom duty for crude oil export were confirmed.

In that way, Decree #328 provided for the crude oil export duty levy. The Decree #328 was officially announced on 17 April 2008 and implemented on 17 May 2008.

According to Clause 3-1 of the Decree #328 export custom duty rates established by this Decree on exported crude oil from the customs territory of the Republic of Kazakhstan **<u>are not applied</u>** to crude oil exports, with a contract that provided for an exemption from custom duty for crude oil exports.

The question of the availability or absence of exemption from custom duty for crude oil export is at issue. Some contracts provide for an absolute exemption from custom duty for crude oil and oil products export, namely the right to duty free export. Other contracts provide only general

provisions on contract stability, namely on the stability of Kazakhstan Legislation enforced on the date of signing the contract and the inapplicability of the following changes and amendments in legislation to subsoil user work under the contract. With regards to the exemption from custom duty for crude oil export it is possible that export duty is the basis for the following negotiations on sub oil users tax burden.

At first, it is notable that custom duty for crude oil export is a temporary measure. The Government representatives only suggested that the Government **could make** a decision on the exemption of custom duty for crude oil export after a new Tax Code levy. Furthermore Decree #328 does not provide any provisions on the time limitation of custom duty for crude oil export. Therefore, it could be said that the custom duty for crude oil export would not impact on the following negotiations between subsoil users and the Government on changes in the tax regime under the new Tax Code.

Over the next few years the Government is likely to substitute customs duty for crude oil export with rental tax and severance tax. Furthermore, the calculation order and the rates of the rental tax will probably be changed (strengthened). The rental tax was introduced from January 1, 2004. However, the majority of mining contracts have been signed in more recent years, and consequently, subsoil users do not pay the rental tax on the exported oil extracted under such contracts. The introduction of the rental tax in 2004 did not affect the tax burden of the subsoil users as they had been protected by the tax treatment stability guarantee approved in the mining contract. As, was mentioned earlier, nobody could even suppose that the government would either constrain oil export or introduce custom duties for crude oil export. The investors have been more interested in such issues as the tax free import of the prospecting and mining equipment. As a result the majority of mining contracts of the nineties are not clear enough regarding the regulation of customs treatment in relation to the oil export contract activity. Yet, such gaps can, apparently, become a reason for the appliance to them of such custom duty for crude oil export payment obligations.

According to decree #328, the custom duty for crude oil export will be calculated net of transit and other additional expenses (oil discharge and loading expenses, in transit insurance). In this case, companies mining and exporting oil in small volumes carry significant losses since their transit expenses are higher than the expenses of other companies with large export deliveries. There is, accordingly, direct evidence of tax burden differentiation between different levels and scales of exporters.

Furthermore, in case the custom duty for crude oil export initiators identify the reason for its implementation as a need for further tax on the part of super-profits received by the mining companies because of the high oil prices, then there is an excess profit tax meant for subsoil users, known as super-profits taxation. It should be very carefully and correctly administered indeed.

With regard to the elaboration of a new Tax code the most fundamental issues are the questions of calculation and the payment order of the severance tax, new order of the rental tax calculation, abolition of the Production Sharing Contract as a contract model and tax treatment stability issues.

It is likely that severance tax will work according to the custom duty for crude oil export principle. The tax object will be the actual volume of the extracted mineral resources, the tax basis will be the cost of the resources based on the average prices fixed at the International (London) Stock Exchange. Transit expenses and other costs will not be accounted for. In another words, it is the profit that will be taxed, and not the gross income net of expenses. According to the current more

balanced model the subsoil users pay corporate income tax, plus super-profits tax.

The suggested new order of rental tax calculation and payment also envisaged that the calculation of the tax will be net of transit and other expenses. One of the main reasons for such a proposal is that is it rather difficult to administrate the rental tax in its present form, since the subsoil users artificially increase transit expenses (increases to drivers' salaries, expensive construction, penalties for transportation companies and so on). Extension of the tax burden because of difficulties in tax administration process is unjustified, as those are incommensurable instruments. Following such principles corporate income tax could be calculated net of expenses, as, for example, it is difficult to check the authenticity of such expenses with validating documents etc.

A similar situation is observed in the issue regarding the abolition of the Production Sharing Contract. It is difficult for the Government to administrate reimbursable expenses from mining projects, which is why there was a proposal to repeal the Production Sharing Contract as one of the mining contract models.

Certainly, all these issues (severance tax levy etc.) must not affect the subsoil users interests working under the mining contracts in which tax regime stability is already provided. Tax audits in 2007 showed that in some cases tax authorities tried to prove the lack of provisions in tax regime stability in mining contracts and in Production Sharing Contract, in order to introduce tax legislation provisions instead of the stabilized tax regime. Some specialists are of the opinion that the stability of the tax regime must be seen only as the immutability of royalties and bonus rates stability, which is confirmed in the mining contract. Therefore it is very important to keep and repeatedly confirm the stability of tax regimes in mining contracts concluded before 1 January 2004. However, tax regime stability also provides for the immutability of tax legislation enforced on the date of signing of the mining contract.

Finally as regards the Draft Law of the Republic of Kazakhstan on Government monitoring of the application of transfer pricing which is currently being considered by the Senate. The only positive thing in this Draft law is the opportunity to receive the agreement of the tax body on applicable prices. Generally, the Draft Law deals with a further tightening of the legislation.

An example of this increased tightening is that earlier assumed distortions from the market price in transactions between independent parties limited to within 10 %, but now **every** distortion from the market price should be accepted as an offence. Such kind of imperative norms make Kazakhstan companies less competitive than foreign exporters.

In a summary of the fourth stage it must be noted that the Government does not disguise its intentions to receive as much as possible of the budget receipts from growing crude oil prices. For that purpose, such kinds of tax enforcement like custom duties for crude oil export are used.

When analyzing the changes of Government tax policy illustrated by the tax legislation amendments, the fundamental tightening of the subsoil user taxation is clearly evident. The next 1-2 years will be crucial in determining the future for subsoil use tax legislation as the Government will try to reconsider tax regimes, determined in mining contracts which were concluded in the nineties according to the new rules as will be provided in the new Tax Code. Perhaps, all these and many other issues will become subjects for dispute and active discussions.