Russia publishes draft law on a tax and customs regime for shelf projects

Government Regulation No. 443-R of 12 April 2012 required the Ministries of Finance, Energy and Economic Development, with the participation of interested federal executive bodies and organizations to develop and submit to the government co-ordinated proposals pertaining to a proposed tax and customs regime for new projects for the development of offshore hydrocarbon deposits. On 15 May 2013, a draft law covering the implementation of this regime was published. The draft law applies to projects within Russian internal sea waters, its territorial sea, on Russia’s continental shelf and in the Russian sector of the Caspian Sea which provide for commercial extraction to commence after 1 January 2016. The draft law proposes amendments to the Tax Code with respect to the mineral extraction tax, profits tax, VAT and personal income tax (PIT). It also amends the law concerning the Customs Tariff.

The draft provides definitions for tax purposes of “hydrocarbon deposit development project,” “operator of a new offshore development project,” “the date of start of commercial production of hydrocarbons,” “hydrocarbon deposits” and a number of other concepts which were not defined in Government Regulation No. 443-R. The term “new offshore hydrocarbon deposit development project” means a shelf project for which commercial extraction of hydrocarbons at the subsurface site begins no earlier than 1 January 2016.

The special tax and customs regime is to apply to the developers of new offshore hydrocarbon deposits, with developers being the license-holder or an operator. An organization may be recognized as an operator if the operating agreement concluded between it and the license-holder satisfies numerous criteria and has been registered with the tax authorities. In addition, the operator must wholly or partially assume risks in relation to at least one of the following in relation to a shelf project:
Prospecting and appraisal,
Hydrocarbon extraction, and
The manufacturing of LNG or the processing of gas condensate (from hydrocarbons extracted at the new offshore hydrocarbon deposit).

The risks assumed may be production and/or technological in any of the above three stages or financial in the case of prospecting and appraisal. A company can quickly lose the status of operator, and thereby cease to qualify for the special regime, on various grounds specified in the draft.

Mineral Extraction Tax (MET)
The proposed tax base is the value of extracted commercial minerals subject to a calculated minimum. The value of a unit of natural fuel gas, of dewatered, desalted and stabilized oil, or of gas condensate is to be determined on the basis of the average level of the actual selling prices of those goods for a tax period (a calendar month), but not lower than threshold prices which are to be determined in accordance with a procedure to be established by the Government.

Offshore projects are to fall into one of four categories. Special ad valorem MET rates for hydrocarbons will be established for each category to apply for a fixed period.

The categories and MET rates proposed are as follows:

1. Category one: deposits which lie wholly in the Sea of Azov or at least 50% within the Baltic Sea - the MET rate will be 30% for 60 months after production begins, but not later than 31 March 2022.
2. Category two: deposits lying at least 50% within the Black Sea (up to 100m deep), in the Pechora and White Seas, in the Russian sector of the Caspian sea, in the southern part of the Sea of Okhotsk (south of 55 degrees north latitude), or the shelf of Sakhalin Island - the MET rate will be 15% for 84 months after production begins, but not later than 31 March 2032.
3. Category three: deposits lying at least 50% within the deeper waters of the Black Sea, the north part of the Sea of Okhotsk (at or north of 55 degrees north latitude) or the southern part of the Barents Sea (south of 72 degrees north latitude) - the MET rate will be 10% for 120 months after production begins, but not later than 31 March 2037.
4. Category four: deposits with 50% or more of their area in the Kara Sea, the northern part of the Barents Sea (at or north of 72 degrees north latitude) and the eastern Arctic - the MET rate will be 5% for 180 months after production begins, but not later than 31 March 2042.

The general MET rules as to the tax base and tax rate will apply after the expiration of the above incentives.

Export Duties
Organizations which extract hydrocarbons at new offshore deposits are to be exempt from the payment of export duties on hydrocarbons extracted at those deposits on the same grounds and subject to the same time limits as set for MET rates. No time limits for exemption from export duties were prescribed in Government Regulation No. 443-R.

Profits Tax
The profits tax rate is to be 20%. It cannot be reduced by regional governments and all profits tax is to be payable to the federal budget.

Ring-fencing
Ring-fencing rules will apply to shelf projects. Income and expenses are to be recorded separately for each shelf project by license holders and to operators of shelf projects. No such rules apply to onshore exploration and production activity. Income from activities associated with the implementation of a shelf project cannot be reduced by expenses associated with other activities or other shelf projects (this requirement will not apply to service companies acting as contractors with respect to the development of offshore deposits). Where the activities of an operator give rise to a permanent establishment (PE) in Russia, the ring-fencing rules will also apply with respect to the determination of the separate tax base for profits tax for such PEs.

Taxation of foreign operators
Activities carried out by a foreign company which is recognized as an operator involving extraction at a new offshore hydrocarbon deposit are to be recognized as activities of the company in Russia. If a foreign
operator carries out hydrocarbon extraction activities relating to a single new shelf project through multiple divisions, it is to have the right to calculate the profits tax base on an aggregate basis provided that all divisions included in the group apply the same tax accounting policies and pay profits tax for that group through a single division designated by the taxpayer. This will be helpful in avoiding trapped costs and disputes with the tax authorities concerning the proper allocation of project costs among such divisions.

**Loss carry forward**
Losses arising from a new shelf project may be carried forward indefinitely by developers for relief against income arising from the project.

**Cost allocation**
Where expenses cannot be directly attributed to a particular shelf project, the tax base must be reduced by an amount corresponding to the proportion of such expenses which is attributable to activities associated with the new project based on a methodology to be chosen by the taxpayer. This methodology cannot be changed more than once every five years. The taxpayer can request approval of the methodology by the tax authorities.

**VAT**
The Russian continental shelf is to be equated with territory under Russian jurisdiction for the purpose of determining the place of sale of hydrocarbons extracted from an offshore hydrocarbon deposit, the place of supply of services and the place of rendering work. The draft law also establishes a 0% VAT rate on export sales of hydrocarbons extracted from a new shelf project and processed products (stable gas condensate and LNG). The place of supply of such hydrocarbons and of services and works rendered in the territory of a new shelf project will be recognized as territory under the jurisdiction of the Russian Federation.

**Transfer Pricing**
It is proposed that the transfer pricing rules in part one of the Tax Code will apply to all significant transactions entered into by a developer of a shelf project with third parties deemed to be interdependent with it and to sales by developers of extracted hydrocarbons and of processed products if the amount of such transactions with the counterparty exceeds 60 million roubles in a year. Notably, transactions between the license-holder and the operator will not be subject to transfer pricing control (other than presumably any sales of extracted hydrocarbons and processed products in excess of 60 million roubles in a year).

**Status**
Currently the draft is intended to enter into force from 1 January 2014. It has yet to be submitted to the Duma and is best regarded as a work in progress. There are, for example, significant issues to be resolved in relation to when a company can be recognized as an operator qualifying for special treatment under the proposed regime. Also, the draft does not address the treatment of expenditure incurred in relation to qualifying projects before the new regime enters into force. It requires an operating agreement to be registered by 30 October 2013 in order for the operator to be recognized as such in 2014. This may not be possible in practice given that the terms of operating agreements are unlikely to be finalized before the laws introducing the essential tax and customs measures have been fully enacted. So it is clear that changes will be made.
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