

RUSSIAN FEDERATION TAX LEGISLATION IMPACTING RUSSIA BASED OIL & GAS OPERATIONS: ENDLESS (?) TRANSITION

William P. Streng†

TABLE OF CONTENTS

I.	INTRODUCTION	556
II.	ACTIVITIES OF THE PROJECT'S TAX AND FISCAL ADVISORY GROUP	558
A.	The Directive to the Tax and Fiscal Group	558
B.	Early Discussions—What Minimum Return Produces Necessary Investment Incentive?	559
C.	Subsequent Tax System Evolution	561
III.	COMPREHENSIVE OVERVIEW OF THE RUSSIAN TAX SYSTEM	562
A.	The Components of the Russian Tax System	562
B.	The Economic Impact of the Russian Tax Structure	563
C.	Tax Administration	564
D.	Coordination with Business Organization Requirements	566

† Vinson & Elkins Professor of Law, University of Houston Law Center; Co-Reporter, Tax and Fiscal Group, Russian Petroleum Legislation Drafting Project at the University of Houston.

The author appreciates the assistance of Greg Vojack, a student at the University of Houston Law Center, for various information provided for this article and, also, to the editors of the *Houston Journal of International Law* (particularly Kelly Herzik, Executive Editor) for their immense editing efforts concerning this article.

- IV. THE INCOME TAX SYSTEM 567
 - A. Summarizing the Legislative Evolution of the Income Tax Provisions 567
 - B. Early Development/Determining the Tax Base . . 568
 - 1. Determining Taxable Income 568
 - 2. Overall Method(s) of Accounting 569
 - C. Special Rules for Enterprises with Foreign Shareholders 570
 - D. Special Concerns with Respect to U.S. Foreign Tax Credit Eligibility 570
 - 1. Cumulative Effect of Deviation from a Net Income Tax System 570
 - 2. Deductibility of Interest Expense 571
 - 3. Deductibility of Wages 571
 - 4. Remedial Legislation for Foreigners Only 571
 - E. Special Discovery & Exploration Tax Incentives 572
 - F. Intervention in the Tax Creditability Issue of the Proposed Russia-U.S. Income Tax Treaty 573
 - 1. Description of the Income Tax Treaty 573
 - 2. The Accompanying Tax Treaty Protocol . . . 578
 - 3. Explanatory "Technical Memorandum" 580
 - G. Are the Foreign Tax Creditability Problems Solved by the Tax Treaty? 580
 - H. Present Alternative Entity Structuring Options 582
- V. THE VALUE ADDED TAX 583
- VI. OIL EXPORT TAX 586
- VII. ROYALTY PAYMENT 588
- VIII. WITHHOLDING TAXES 588
- IX. LICENSE FEES 589
- X. OTHER POTENTIAL FINANCIAL COSTS 590
 - A. Other Governmental Charges Imposed 590
 - B. Surrender of Foreign Currency Receipts. 590
 - C. Additional Payment to Fund RSFSR Petroleum Studies 591
 - D. Environmental Taxes 591
- XI. TRANSFER PRICING 592

XII. "SUPERTAX" 593

 A. Applicable Concepts 593

 B. Necessity for a Defined Russian Federation Fiscal Regime 595

 C. International Risk Assessment 595

 D. Tax Creditability or Deductibility of Supertax Payments 597

 E. Quantifying the Net Overall Tax Effect 598

XIII. SEPARATELY NEGOTIATED CONCESSION AGREEMENTS 598

 A. The Thrust Towards Separately Negotiated Agreements 598

 B. Will Separate Arrangements be Recognized on a Continuing Basis? 600

 C. Tax Creditability for the Production Share 601

XIV. THE IMPACT OF INFLATION ON THE TAXING PROCESS 601

XV. EMPLOYEE TAXATION 602

 A. The Income Tax Applicable to Expatriates 602

 B. The Incentive for Tax "Planning" 603

 C. The Impact of the Russia-U.S. Income Tax Treaty 604

XVI. PROSPECTS FOR THE FUTURE 604

APPENDIX ONE:
 SUMMARY OF ACTIVITIES OF THE PROJECT'S TAX AND FISCAL GROUP 608

APPENDIX TWO:
 CASH FLOW CHART 617

APPENDIX THREE:
 SUMMARY OF COUNTRY RISK EVALUATION PROCESS . . 620

APPENDIX FOUR:
 SUMMARY OF OIL & GAS TAXATION IN CERTAIN OTHER COUNTRIES 622

APPENDIX FIVE:
 STRUCTURE OF A POSSIBLE CASH FLOW TAX 629

"Vice President of the Russian Federation Aleksandr Rutskoy has . . . noted that **current conditions do not foster 'the fast flow of overseas capital into Russia.'**"¹

I. INTRODUCTION

Vice President Rutskoy's statement confirms the obvious—and is actually an immense understatement. Investment in an evolving foreign country by an international enterprise (including, particularly, by an international petroleum company in a capital intensive foreign based petroleum exploration and development project) ordinarily occurs only after a determination that a reasonable probability of significant investment return exists. This net anticipated investment return is determined on an after-tax basis, especially when considering the overall tax effect at the foreign location. Accordingly, what initially appears as a positive investment climate in the foreign country can be significantly adversely impacted by an onerous "host country" taxation system. Even though the basic income tax or business profits tax rate does not appear to be excessively burdensome on first observation, by its essential transformation into a gross (rather than net) tax, and through the imposition of many other types of taxes on the same cash flows, the potential to the foreign investor for economic gain can be completely eroded.

This quite important planning issue is being profoundly confronted by those international energy companies who have been seriously investigating possible investment opportunities into the energy sector in the Russian Federation. The Russian tax system, as described in greater detail below, from almost all perspectives appears to be structured, whether by design, inadvertence, or a combination of both, to discourage that foreign based investment to any significant extent, except,

1. *Russia Urges Signapore to Ratify Double Tax Agreement*, Tax Notes Int'l (Daily Serv.), Mar. 24, 1993, available in LEXIS, Fedtax Library, TNI File, at 93 TNI 56-9 (citing *Russia Keen on Wide-Ranging Economic Ties*, THE STRAITS TIMES, March 9, 1993, at 40; *Russia Wants To Ratify Investment Guarantee Pact*, F.B.I.S., March 9, 1993, at 33).

perhaps to those most speculative venturers having the "thousand year view."

As examined in this article, for Russia's evolution from a command economy to a market economy to be genuinely successful (1) the overall cost of the Russian tax structure must be reduced for both foreign and domestic (i.e., Russian) investors; (2) the administrability of the Russian tax system must be significantly improved; and (3) the general stability of the Russian economy, and its legal system, complementing a rational tax system, must evolve if significant investment inbound into Russia is to occur. This legal system must allow, of course, for the foreign investor to repatriate its profits on a timely basis and in a convertible currency, thereby being able to truly measure its economic success in Russia in terms of international economic capacity.

The University of Houston's Russian Petroleum Legislation Project was organized in part to encourage the Russian tax revision effort in the petroleum sector. The various efforts to assist the Russian Federation in the development of a cohesive body of legislation generally dealing with the energy sector are described elsewhere in this issue of the *Houston Journal of International Law*.² A "Tax and Fiscal Group" was an integral part of that legislative effort, with the objective of our Group being to assist in encouraging appropriate tax legislation applicable to both (1) the domestic (i.e., exclusively Russian) sector and (2) the international energy sector investors.³ At a later stage in the evolution of this project our tax effort was conjoined with the endeavors of the World Bank, which has also sought to substantially influence the direction of laws applicable

2. These efforts included the activities of the Licensing Group, described in the article on petroleum licensing by Professor Gary Conine, and the Conservation and Environment Group, described in the article by Professor Jacqueline Lang Weaver. See Gary B. Conine, *Petroleum Licensing: Formulating an Approach for the New Russia*, 15 HOUS. J. INT'L L. 317 (1993); Jacqueline Lang Weaver, *The History and Organization of the Russian Petroleum Legislation Project at the University of Houston Law Center*, 15 HOUS. J. INT'L L. 271 (1993).

3. The Co-Reporters for the Tax and Fiscal Group have been the author of this article, William P. Streng, Professor, University of Houston Law Center; Ray Jones, Partner, Arthur Andersen & Co., Houston; and, Richard Gordon, Arthur Andersen & Co., Washington, D.C. Various industry members were advisors. The group is particularly appreciative to Roger Bonney, Adjunct Professor, UH Law Center, for his assistance in providing certain analyses concerning the Group's discussions.

to the Russian energy sector, particularly in the tax policy context.⁴ Of course, in the tax context, the direction of tax policy cannot merely be limited to one sector, such as the energy sector, so the tax discussion is in many contexts of more comprehensive application.

This article first summarizes the effort of the Tax and Fiscal Group of the University of Houston Law Center's Russian Petroleum Legislation Project to assist in the development of a more accommodating tax structure for both domestic (i.e., exclusively or predominately Russian) and international investment into the Russian petroleum sector.⁵ However, a more important purpose of this article is to examine the recent evolution of the Russian taxation system, particularly as applicable to the energy sector, since the time at which the Russian Federation became an independent nation state. In the process of describing this evolution a variety of fundamental tax issues (some remaining unanswered, perhaps for the indefinite future) are identified and examined.⁶

II. ACTIVITIES OF THE PROJECT'S TAX AND FISCAL ADVISORY GROUP

A. *The Directive to the Tax and Fiscal Group*

The initial directive to our Tax and Fiscal Group was to provide advice and recommendations to our Russian counterparts concerning the appropriate choices for their country's taxation system as their country moves from a command/control economy to a market economy.⁷ Unlike the other University of

4. The World Bank representatives were Charles McPherson of the World Bank; David Craig, Senior Economist, World Bank; Prof. Thane Gustafson of Georgetown University, Professor Peter Cameron, Rijkuniversiteit Leiden, The Netherlands; Professor Alexander Kemp, Aberdeen University; and, Honore Le Leuch, Beicip-Franlab, Paris, France.

5. See the detailed chronological summary of the Group's activities at Appendix One.

6. This article describes the evolution of the various Russian tax provisions through approximately April 1993. Because changes are rapid, by the time this article is published any tax researcher should regard this information as historical, with independent verification required to determine whether these rules remain applicable.

7. During the existence of our project, a variety of other groups provided tax advice, both with respect to energy taxation and generally. These included members of a the U.S. State Department Working Group (consisting of repre-

Houston Project groups which provided definitive legislative drafts, this Group's assistance consisted primarily of a wide variety of guidance provided both in meetings and through extensive memoranda examining important elements of structuring the fundamentals of a taxation system (as applicable, particularly, to the energy sector) in a market economy.

A special difficulty for the Tax and Fiscal Group, never really adequately resolved, was that our efforts, which were coordinated with the efforts of the other UH Project advisory groups, were directed towards representatives of the Russian Federation's Ministry of Fuel and Energy. However, we recognized early that, similar to the situation in the United States, tax policy and proposed tax legislation evolves from a diversity of governmental segments, particularly the financial segment of the executive branch of the national government (e.g., the Ministry of Finance or the Treasury Department), rather than from the relevant subject matter ministry (e.g., the Department of Energy in the U.S. or the Ministry of Fuel and Energy in the Russian Federation). This is not dissimilar from the tax policy decision-making process in the United States, i.e., tax policy even with respect to selected industries primarily evolves from the U.S. Department of the Treasury, rather than from the executive branch's Department of Energy (with respect even to energy tax matters). Similar parallelism exists in the legislative branches.

B. Early Discussions—What Minimum Return Produces Necessary Investment Incentive?

As we commenced our discussions with the Russian tax representatives⁸ one question seemed to overwhelm our preliminary proceedings: the Russians wanted to know the precise rate of minimum investment return that would be acceptable to an

sentatives of U.S. energy companies and coordinated through the U.S. State Department). The U.S. Treasury Department and the Internal Revenue Service have provided advice and information to various tax administrative groups in Russia. Other ad hoc consultative groups seem regularly to be in a process of formation for purposes of seeking to influence the direction of tax policy decisions in Russia.

8. The academic backgrounds of our Russian counterparts were primarily as economists in a command/controlled economic system. They were substantially impacted by their long experiences working within organizations which mandated government prices.

international energy company. We discerned that, having that "magic number" for a foreign investor's "internal rate of return," or "IRR," the Russian representatives would then believe they could recommend a tax system which could have the effective result of appropriating for the government all the cash flow remaining after the allowance of that maximum allowable return. This was partially understandable when realizing that the Russian historic discipline was a system where all profits, particularly with respect to the "national heritage" such as oil, belonged to the state or "the people."

The Russian objective of providing this prescribed rate of return to the international oil company would be merely to constitute facilitating a payment for the foreign company's participation in the project. The Russians rejected any idea that the foreign sourced investment should permit the international investor to participate "on the upside." The Russian side grudgingly but ultimately seemed to accept our proposition that no magic "decision point" (or specified investment return rate) exists for international energy companies concerning whether they will or will not commit to a specific project (whether located in Russia or elsewhere). As their country struggles imperceptibly toward a market economy, our Russian counterparts gradually and more fully comprehended these Western perspectives, but time may not permit that luxury of gradualism for the full absorption of these lessons.

During our discussions, the Russian tax system was emerging into a highly onerous, probably confiscatory, regime. Our Group's representatives regularly inquired (both directly and indirectly) whether, perhaps, by encouraging such an onerous overall tax regime, the ultimate objective of the Russian side was to assure, at least for the near term, that no significant investment commitments would be made by international energy companies, other than through a production sharing agreement mode (whereby production in kind can be repatriated from the country, immunized from certain taxes). We did not really receive a response to this type of inquiry, but we can reach certain conclusions.

Meanwhile, production sharing arrangements began to evolve. A special benefit of production sharing contracts in the Russian context is that each of these arrangements will have been individually crafted. In each instance, this can enable in the Russian side to determine within the microcosm of that

“deal” what the market constraints are perceived to be. This will enable, in turn, the structuring, in essence, of a private taxation system for the purposes of that “deal.” After a number of such arrangements a pattern might evolve to demonstrate to the Russians at what economic level the usual deal should be taxed, while still facilitating international investment. Perhaps this can work in the short term, but the immensity of the energy sector, and the multiplicity of the arrangements, will cause this structure to collapse of its own weight. Thousands of separate taxation structures (identified as concession arrangements) will simply not be administrable.⁹

C. *Subsequent Tax System Evolution*

Meanwhile, the Russian tax system, as applicable to all commercial sectors in Russia, has itself continued to haphazardly evolve.¹⁰ This bumpy process cannot be unexpected where an immense economy is seeking to instantaneously transform itself from a command economy to a market economy. The progression of various elements of the Russian taxation system, as applicable to the energy sector and more extensively, is discussed below. Members of our Tax and Fiscal Group, acting in conjunction with the tax representatives of the World Bank, are hopeful that we have provided appropriate guidance to the

9. Of course, other problems exist in this context, such as the possibilities for corruption because each is a private arrangement not necessarily consistent with the prescribed petroleum concession regime.

10. A fundamental document in this context is the Basic (or Fundamental) Principles of Taxation law, enacted in December of 1991. This law consists of two parts: (1) the first part establishes the “unified” tax structure, general taxation rules, penalties, and tax administration powers; and (2) the second part specifies the taxes that may be levied by the federal, oblast, and rayon governments and assigns the revenue from each tax to the budgets of the various levels of government. Law of the Russian Federation on the Fundamentals of the Tax System in the Russian Federation, Dec. 27, 1991 (Official Text from *Ekonomicheskaya Gazeta* No. 11, Mar. 1992) (on file with the author) [hereinafter Fundamental Principles of Taxation Law]. For an unofficial translation, see Law of the RSFSR Concerning the Fundamental Principles of the Taxation System in the RSFSR translated in Ernst & Young, Commonwealth of Independent States (Formerly Soviet Union) Energy Tax and Financial Working Group (Jan. 7, 1992) (on file with the author). Separate laws governing each tax mentioned in the Basic Principles (and discussed below) have subsequently been enacted: the Law on the Value Added Tax (VAT), the Law on Taxation of Enterprises Profits, Law on Property Tax, and other laws. See discussion *infra* parts III through IX.

various participants in Russian petroleum tax policy so as to facilitate this evolution.¹¹ However, the precise results of our efforts will be difficult to identify, particularly since, in the taxation area, so many other cross-currents have been at work, and will continue to emerge, until a more satisfactory resolution is possible concerning a rational and cohesive tax structure.

The objective in the following segments of this discussion is to examine the Russian tax structure which has been evolving since the inception of the Russian Federation. This discussion unfortunately demonstrates that much of the Russian taxation system remains both onerous and chaotic.

III. COMPREHENSIVE OVERVIEW OF THE RUSSIAN TAX SYSTEM

A. *The Components of the Russian Tax System*

For an international energy company, the Russian tax system can be bewildering, particularly when contemplating a significant investment decision.¹² Further, the information concerning these tax rules is itself often confusing and contradictory.¹³ The variety of taxes and other fiscal costs is sub-

11. The World Bank has produced its own analysis and recommendations concerning the tax system in Russia, including as applicable to the energy sector: CHRISTINE I. WALLICH, *FISCAL DECENTRALIZATION—INTERGOVERNMENTAL RELATIONS IN RUSSIA* (Studies of Economies in Transformation No. 6, The World Bank, 1992). This report notes, as applicable to sharing revenues from natural resources, that Russia's policymakers should examine three issues: (1) how taxes on the resource sector should be structured; (2) how resource revenues should be shared among jurisdictions; and (3) how resource revenues should be used. *Id.* at 13.

12. Consider, however, that, for a foreign investor coming into the United States energy sector, the U.S. based assortment of tax and other fiscal costs might be similarly perplexing. In the United States, these can include the complexity of multiple layers of governmental taxation. The difference is, however, that, after identifying all these probable costs, a conclusion can be reasonably developed (1) concerning the likely overall financial impact; (2) that those anticipated costs will probably be within anticipated ranges; and (3) that extrinsic factors such hyper-inflation will not radically skew those contemplated results.

13. Increasingly, information sources concerning Russian tax rules are improving, including information provided by various large accounting firms and law firms having Moscow offices and special reports in such publications as *TAX NOTES INTERNATIONAL*. However, some of this information is based on Moscow news reports which may not be completely accurate. Further, as noted below, the tax administrative capabilities are only evolving; and, consequently, the non-

stantial, the taxes are complex, and their effect is often not consistent with standards in a market economy environment.¹⁴ Further, investors (both domestic and international) must anticipate that, like a child learning to walk, many trial and error efforts must be made before the system becomes more refined and sophisticated, at which point the evolution of the Russian economy will necessitate further adjustments.¹⁵

Those taxes and related fees which are germane in the energy sector (and obviously impact on the "net take" from an exploration and development project) are ordinarily identified as including the income tax, the value added tax, various royalties required under the specific licensing agreement, a highly disputed "export tax" on the export of oil, a foreign currency conversion requirement (which effectively constitutes a tax), and other miscellaneous fees and charges. For the domestic (i.e., Russian) enterprise the obligation to sell at the domestic regulated price, rather than the world price, also itself constitutes a "tax."

B. *The Economic Impact of the Russian Tax Structure*

A particular difficulty in the context of Russian taxation of Russia based petroleum operations is that, from the perspective

inal rates and the effective tax rates may be dramatically different.

14. See *Russian Tax Service Examines 1992 Results*, Tax Notes Int'l (Daily Serv.), Oct. 28, 1992, available in LEXIS, Fedtax Library, TNI File, at 92 TNI 59-5.

Describing Russia as a "tax desert" in the recent past, the Russian Federation Main Tax Service characterized its tax system currently as a small garden, sporting approximately 40 different forms of taxation. The results of the past year were reported to be mixed, with dramatic increases in the amount of taxes collected in some areas, balanced by greater tax evasion in others. The Service noted that old and new businessmen alike complain that their taxes are too heavy, although experts' calculations show that the actual burden is lighter than before. Nearly all revenue was collected through four types of taxes: the tax on profits (45% of all revenue); the value-added tax (33%); the income tax (10.6%); and the excise tax (just over 5%). In absolute figures, for the first seven months of 1992, 1,218 billion rubles were collected — one third less than planned.

Id.

15. For an article discussing Russia's tax system, see John Turro, *Emerging Market Economies: Russian Tax System Remains in Flux, Particularly Profit Tax Rules*, 4 TAX NOTES INT'L 1075 (1992). See also WALLICH, *supra* note 11, at 29 (a summary entitled "Recent Tax Reforms in the Russian Federation") and 121-41 (Appendix 3 entitled "Russian Federation, Tax Summary as of March 1, 1992" providing an extensive description of the various taxes).

of the international energy company investor; the total government revenue sought to be obtained from international energy companies is unprecedented. This observation is particularly germane when the element of political risk is factored into this equation. The structure of the government taxation system, which relies almost exclusively on revenue based taxes (i.e., particularly those imposed on gross amounts), rather than net profits taxes, is strongly regressive. If maintained for the future, this tax structure is almost certain to preclude the most necessary investments, except to the extent those arrangements can be circumvented with out-of-country product swaps, countertrade deals, transfer pricing gimmicks, and other indirect mechanisms to frustrate the intended application of the tax system in a particular investment situation. Ultimately, however, immense political pressure and, thereby, economic risk, exists for structuring a major transaction premised subject to these types of cash-flow reduction techniques.

C. Tax Administration

A capable tax administration and procedural system also needs desperately to be developed in Russia.¹⁶ Tax collection and tax compliance is a major problem facing Russia's central government.¹⁷ The Russian side recognizes this tax administra-

16. See Fundamental Principles of Taxation Law, *supra* note 10, art. 25. The Russian government announced on January 6, 1993 that it plans to recruit thousands of former Soviet KGB officers for a new tax inspection service. "The move is an attempt to put some teeth into the country's tax laws, the administration of which has been lax at best, and to offset the revenue losses that will result from tax cuts that went into effect on January 1 [1993]." *Russia Plans New Tax Inspector Service Using Former KGB Agents*, Tax Notes Int'l (Daily Serv.), Jan. 11, 1993, available in LEXIS, Fedtax Library, TNI File, at 93 TNI 6-10 (citing *Russia Modifies Taxes But Gets Tough With Tax Dodgers*, UPI, Jan. 6, 1993).

17. Maria Polunina, Chair of the Committee on Budget Control of the Supreme Soviet, has said that about one-third of all commercial enterprises in her country do not pay taxes on their profits. The government has concluded that for any tax system in Russia to work, the country must improve its tax collection system. Consequently, the government has decided to institute militarized tax collection bodies formed by the police to ensure compliance with tax laws. John Turro, *A Supply-side Prescription for Russia*, Tax Notes Int'l (Daily Serv.), Aug. 19, 1992, available in LEXIS, Fedtax Library, TNI File, at 92 TNI 34-7 (citing Maria Polunina, Chair of the Committee on Budget Control of the Supreme Soviet of Russia, Report Presentation at the Heritage Foundation Conference on Russia's Transition to a Free Market Economy (Aug. 5, 1992)).

tion and collection issue as an important ingredient of creating the right climate for foreign investment,¹⁸ but implementation of this concept is obviously difficult in a country where a voluntary tax compliance system has really never previously existed.¹⁹ The existence of a cash economy, and the lack of a functioning banking system, accomodates this result.

Further, the lack of coordination among a variety of government agencies having jurisdiction over Russian based petroleum taxation creates a quite debilitating environment for encouraging international investment into the Russian petroleum sector. In the United States, by contrast, multiple state and local jurisdictions, in addition to the federal government, impose taxation on the energy sector, but the allocation of that jurisdiction is relatively well defined. The states and local governments recognize that they cannot attempt to displace the functions of the national government, and the national government recognizes the U.S. constitutional limitations with respect to the imposition of certain types of taxes, including on the energy sector. All of these conditions in the United States result in a reasonably stabilized investment environment, although some would always assert that the overall "government take" is too great and does not encourage appropriate reinvestment and risk-taking in the important domestic energy sector.

18. Note, for example, that the Deputy Head of the Russian tax service was arrested on bribery charges and accused of accepting bribes from a foreign computer company. The Chairman of the Tax Service had earlier been relieved of his duties for unexplained reasons. See Jeffrey M. Trinklein, *Deputy Head of Russian Tax Service Arrested on Bribery Charges*, Tax Notes Int'l (Daily Serv.), Mar. 31, 1993, available in LEXIS, Fedtax Library, TNI File, at 93 TNI 61-2.

19. The Russian Tax Inspectorate (Moscow division) has indicated that it intends to close the bank accounts of foreign firms registered in Russia that have not filed their annual statements of account as required by Russian law. The Russian business newspaper *Kommersant Daily* reported that during a January 21, 1993 briefing, the Tax Inspectorate announced that hundreds of foreign firms that had reported activities for 1991 had failed to file the necessary statements for 1992. The Tax Inspectorate reported that 320 foreign firms had filed the necessary returns and 63 had paid a total of 2.2 million rubles (then U.S. \$4,400) in taxes. The Tax Inspectorate also announced that, to increase compliance by foreign firms and individuals with Russian tax rules in 1993, it will create a special division dealing only with foreign firms. See David M. Ayres, *Russian Tax Authorities to Crack Down on Foreign Companies*, 6 TAX NOTES INT'L 262 (1993).

D. *Coordination with Business Organization Requirements*

The evolution of the Russian taxation system is occurring parallel with the development of a legal structure concerning the requirements and formalities of business organizations in Russia. The types of recognized business organizations in Russia include partnerships, joint stock companies, and representative offices.²⁰ Partnerships, both full and mixed, are a relatively new concept in Russia. The principal feature is unlimited liability for the partners, although certain partners in a "mixed partnership" have limited liability. The limited (or mixed) partnership is considered to be a legal person in its own right and, as such, has the ability to sue and be sued in its own name. It must also file a tax return and pay its own taxes. In contrast to the mixed partnership, the full partnership is not considered by Russian law to have any legal right of its own. Its profits are deemed to be the income of the partners and to pass through to those partners for tax purposes.²¹

Joint stock companies are of two varieties, open and closed joint stock companies. The shares of a closed joint stock company are not freely transferable. However, in an open joint stock company, share transfers are not restricted. The minimum incorporation for a closed joint stock company is 10,000 rubles, and the open joint stock company must have an initial capital of at least 100,000 rubles.²²

Representative offices are widely used by foreign companies in Russia. These offices do not directly engage in operational activities. They merely refer business to the foreign entity which they represent. The scope of their activities will deter-

20. See Law of the Russian Federation on Income Tax from Enterprises, Dec. 20, 1991 (Official Text of Law No. 2070-1 of the RSFSR, received as a draft from a Government Source and then corrected through comparison with the *Rossiskaya Gazeta*) (on file with the author) [hereinafter *Enterprise Income Tax*].

21. This latter system is similar to the flow-through treatment applicable in the United States to partnerships subject to Subchapter K of the Internal Revenue Code.

22. See Presidential Decree No. 721, Decree on Organizational Measures to Transform Russian Entities into Joint Stock companies, July 1, 1992 (on file with author) [hereinafter *Presidential Decree No. 721*]. With the immense devaluation of the ruble, this is not a serious consideration for foreign investors, although obviously it can be an important requirement for some Russian investors.

mine whether they have any income to be reported to tax authorities.²³

IV. THE INCOME TAX SYSTEM

A. *Summarizing the Legislative Evolution of the Income Tax Provisions*

The income tax legislation applicable to business enterprises in Russia consists of the enterprise profits tax, imposed at a rate of thirty-two percent. Resident companies (i.e., those incorporated in Russia) are taxed on their worldwide income. This treatment might be moderated by reason of an applicable income tax treaty.²⁴ The thirty-two percent rate is applicable to both resident and nonresident companies.²⁵

The starting point for calculating taxable profit is the profit disclosed in the company's statutory accounts. Adjustments are then made for profits tax purposes.²⁶ In computing this profits tax, not all wages and other employee costs are deductible.²⁷ The deductibility of certain interest expense is also limited. A second business profits tax, the enterprise income tax, was

23. The normal objective will be to avoid have sufficient presence in Russia to trigger tax nexus in Russia. See the discussion below of the "permanent establishment" provision in the proposed Russia-U.S. Income Tax Treaty. See *infra* notes 55-56 and accompanying text. That discussion identifies when tax jurisdiction will attach because the parties are within the scope of the provisions of that treaty defining situs business activity.

24. See the discussion below of the proposed Russia-U.S. Income Tax Treaty and also note that Russia is negotiating similar treaties with various other countries. See *infra* notes 63 and accompanying text.

25. See also Instruction of the State Tax Inspectorate of the Russian Federation on the Taxation of Profits and Incomes of Foreign Legal Entities, May 27, 1992 (on file with the author) (incorporating this 32% rate). The Enterprise Income Tax, *supra* note 20, will come into force in replacement of the Enterprise Profits Tax when determined by the Supreme Soviet and the Russian government. Many of the concepts in these two laws are similar. Instead of this income tax, foreign legal entities have the right to pay under the Enterprise Profit Tax. See Enterprise Income Tax, ch. II, art. 6(5).

26. Enterprise Income Tax, *supra* note 20, ch. II, art. 4. Tax depreciation is the same as depreciation for accounting purposes. The statutory rules on depreciation rates are highly specific, extending to over 100 pages. Depreciation is computed on a straight line basis. With hyper-inflation this deferred recovery of business asset cost produces only limited tax savings value.

27. Deductible salary is defined as the minimum wage, multiplied by four for each employee. The monthly minimum salary as of December, 1992 was 900 rubles.

scheduled to replace this profits tax. Under the enterprise income tax, the wages and other employee costs would not be deductible, and the rate would be eighteen percent. As noted below, for U.S. investors, the application of this business profits tax is impacted by provisions in the Protocol to the proposed Russia-U.S. income tax treaty.

B. *Early Development/Determining the Tax Base*

1. Determining Taxable Income

The Russian income tax system purports to be a "net income" system, rather than a gross income tax system, but the concept of "net income" may be in the eye of the beholder.²⁸ For the U.S. investor (and some other investors "foreign" to Russia) this is important from several perspectives:

(1) Is the tax a "creditable" foreign tax if paid (directly or indirectly) by a foreign investor, thereby enabling a full offset against the income tax imposed by the investor's home country on that Russia based income when (currently, or upon eventual repatriation) included in residence country income?

(2) What is the "effective rate" of tax which (without even considering the probable economic impact of inflation or hyper-inflation) may be significantly different from the nominal rate of taxation?

In the United States, we must certainly recognize that the definition of net income for federal income taxation purposes is far from consistent with the economic measurement of income.²⁹ This is why "net income" might be measured differently in the United States for federal income tax purposes, state income tax purposes, financial accounting and reporting to shareholders and other owners or bankers, and for reporting to other federal, state, and local regulatory agencies. However, under all of these different systems, fundamental expenses are associated with the related income (or the tax is transformed

28. Enterprise Income Tax, *supra* note 20, ch. II, art. 4.

29. Of course, many of these differences between net income for federal income tax purposes and generally accepted accounting principles ("GAAP"), such as for depreciation policy, result intentionally from tax policy decisions to provide incentives for certain activities.

into more of a gross receipts or gross income tax). In the Russian taxation system, however, extensive but even more confusing, and sometimes contradictory rules, are applicable with respect to determining how to proceed from the level of gross income to net income. Because of the limitations on some deductions,³⁰ the system might more appropriately be described as reaching "modified gross income."³¹

2. Overall Method(s) of Accounting

In the United States, the overall method of accounting is ordinarily either the cash receipts and disbursements method of account or the accrual method of accounting.³² The overall accounting system applicable in Russia for tax computation purposes appears to be a mixture of the cash method and the accrual method.³³ For example, when products are sold on the foreign market and the documents are submitted for payment, the amount to be paid will be considered as constituting income as of that time. However, for domestic sales, income is not to be treated as realized until the cash payment is actually received.

Expenses apparently are to be recognized on a cash basis, with the exception of wages and salaries and certain accruals such as warranty costs.³⁴ However, this treatment might be changed if internationally accepted accounting principles are implemented.

30. E.g., limitations on the deductibility of wages and interest expenses, as discussed more fully below. See *infra* notes 37-39 and accompanying text.

31. See the discussion below concerning the attempt under the Protocol to the Russia-U.S. Income Tax Treaty to solve this dilemma of assuring reasonable classification of the Russian income tax system as reaching "net income." See *infra* notes 73-79, and accompanying text.

32. I.R.C. § 446 (1988). The accrual method is required for those taxpayers having inventories. Consequently, the accrual method will be applicable to many U.S. investors into Russia, except for service providers.

33. The United States also superimposes a cash method of accounting on accrual basis taxpayers in some situations (e.g., prepaid income) and an accrual method on some income items received by cash basis taxpayers (e.g., original issue discount (OID) current income inclusion).

34. This exception apparently results substantially from the environment in Russia whereby checks are not used, but funds are conveyed either by wire transfer or in the form of cash.

C. *Special Rules for Enterprises with Foreign Shareholders*

Chapter 2 of the Income Tax Law "Concerning Income Tax on Enterprises" has apparently been structured to respond to the argument that net income is the appropriate base for taxation of business income. The indicated objectives seem to be to provide for a more accurate determination of economic income of the enterprise, thereby facilitating the availability to foreign investors of the foreign tax credit (if pertinent under their tax systems), and also providing for more stability of the tax system. Whether these objectives have been accomplished is debatable, as discussed below.

D. *Special Concerns with Respect to U.S. Foreign Tax Credit Eligibility*

1. Cumulative Effect of Deviation from a Net Income Tax System

Concern exists as to whether the Russian business profits tax as presently imposed on business operations will really be a creditable tax for determining net income tax liability in the home country of the international investor. Under the U.S. income tax system a credit is provided for foreign income taxes paid to a foreign country, thereby eliminating or modifying the potential impact of double taxation on the foreign based income.³⁵ However, the foreign tax is creditable for this purpose only if based on concepts similar to net income taxation in the United States. This concern over eligibility for the credit in the Russian taxation context has existed because of both (1) the cumulative effect of the various deviations from the measurement of net income pursuant to U.S. standards; and (2) the specific disallowances of certain deductions.³⁶

35. I.R.C. §§ 901-07 (West Supp. 1993). A credit, or some other adjustment mechanism, is necessary to avoid double taxation since the U.S. income tax system is imposed (under I.R.C. § 61 (West Supp. 1993)) on a worldwide basis, rather than on a territorial basis.

36. *But see* Scott R. Schmedel, *Tax Reports*, WALL ST. J., Dec. 18, 1991, at 1 (indicating that Edward Lieberman, described there as a Washington lawyer specializing in the subject, had stated: "I think the 1991 Russian income tax will be creditable against U.S. income tax."). That report further indicates that "Russian legislators have discussed revisions that could make the 1992 tax differ too much from America's to qualify for credits." *Id.*

2. Deductibility of Interest Expense

Interest expense on debt provided by joint venture owners may not be deductible in reaching net income.³⁷ This deduction disallowance could perhaps be circumvented by routing the loan through a bank on a back-to-back (or "conduit") basis, assuming that the Russian tax authorities would not inquire about or impose any type of look-through rule.³⁸ However, transforming interest into being payable to a financial institution, and, therefore deductible, also does not necessarily solve the foreign tax credit eligibility issue.

3. Deductibility of Wages

A limitation also exists under the income tax on the deductibility of employee wages. This limitation on tax deductibility exists because of a concern that, absent such a limitation on this deduction, all wages will be paid to the workers of the Russian enterprise. The result would be that no net income would remain to be subjected to the Russian net income tax.

This limit on wage deductions also has the probable effect of transforming the tax from a net income tax into a gross income tax. Therefore, at least under U.S. income tax standards, this tax would not be creditable for foreign tax credit purposes, except as this limitation might be modified under an applicable income tax treaty.³⁹

4. Remedial Legislation for Foreigners Only

In 1992, revisions to the corporate profits tax provisions limiting interest expense and wage expense deductions survived

37. See the reference to the interest expense deduction limitation under the Enterprise Income Tax at WALLICH, *supra*, note 11, at 122.

38. Compare the perspective of the IRS concerning conduit arrangements in such pronouncements as Rev. Rul. 87-89, 1987-2 C.B. 195, where, for purposes of the withholding tax on interest under I.R.C. §§ 881 and 1442 (West Supp. 1993) (and for purposes of determining whether a controlled foreign corporation has an increase in its earnings invested in United States property under I.R.C. § 956 (1988)), a lender was considered to have made a direct loan to a related borrower where the lender deposited funds with an unrelated entity and that entity, in turn, lent funds to the borrower.

39. See *infra* notes 73-79 and accompanying text (regarding the discussion in the context of the Russia-U.S. Income Tax Treaty proposed during 1992).

in somewhat revised and limited form. However, the Supreme Soviet passed a separate decree declaring that the limitations on deductions will not apply to Russian entities all of whose equity is owned by foreigners (except foreigners from members of other countries in the Commonwealth of Independent States).⁴⁰ Registered representative offices of foreign companies also have been exempted from this limitation. However, no similar exception was made for Russian companies (including most Russian joint ventures) that are only partly foreign owned. Therefore, most corporate joint ventures will not benefit from this revised rule.

E. Special Discovery & Exploration Tax Incentives

At various times, the Russian side discussed the structuring of special tax incentives for the oil and gas industry for incorporation into the income tax system.⁴¹ However, questions remain whether the Russians are actually considering special incentives for exploration and discovery costs for purposes of computing the income tax liability.⁴² In the computation of the

40. David M. Ayers, *Russian Supreme Soviet Enacts Major Changes to VAT, Profits Tax, and Individual Income Tax*, 6 TAX NOTES INT'L 174, 175 (1993) [hereinafter Ayers, *Major Changes to VAT*].

41. The Russian Supreme Soviet has begun to understand the importance of certain tax incentives. See David M. Ayers, *Russia Proposes Tax Benefits for Small Businesses*, Tax Notes Int'l (Daily Serv.), Apr. 19, 1993, available in LEXIS, Fedtax Library, TNI File, at 93 TNI 74-2 (citing the MOSCOW KOMMERSANT DAILY, Apr. 8, 1993, at 9). This new information indicates that on April 7, 1993, the Russian Presidium of the Council of Ministers approved, in principle, a series of measures to assist the growth of small and medium-sized businesses. These measures would incorporate a number of significant tax benefits, including:

- (1) an exemption from the 1% tax on company assets for those assets placed into special investment accounts for the purpose of increasing production;
 - (2) a reduction in the profits tax for having created additional jobs;
 - (3) freedom from import taxes;
 - (4) a reduction in the profits tax in the third and fourth years of operation.
- The tax and other benefits are designed to assist small to medium-sized businesses in the priority areas of food production and processing, services, construction, and the manufacture of consumer goods. No details the proposed decree (e.g., the sizes of the businesses intended to benefit, or the extent of the tax reductions proposed) were given, since there was not unanimous agreement among the government ministers as to the best way to formulate the program. A final version of the decree is not expected until May 1993.

Id.

42. Enterprise Income Tax, *supra* note 20, ch. II, art. 4, does indicate that

discussed "supertax," all these costs would apparently be permitted to be recovered prior to the applicability of that (possible) tax.

F. Intervention in the Tax Creditability Issue of the Proposed Russia-U.S. Income Tax Treaty

1. Description of the Income Tax Treaty

A revised Russia-U.S. income tax treaty was signed in Washington on June 17, 1992.⁴³ In a sense, it is not a "revised" treaty since it is the first treaty with the Russian Federation, a new nation. However, it is generally deemed to constitute a replacement of the U.S.S.R.-U.S. income tax treaty implemented in 1973.

material costs include costs are deductible (and these can include costs connected with using natural resources such as allocations to cover the cost of geological explorations and geological prospecting work for minerals).

43. Convention for the Avoidance of Double Taxation, June 17, 1992, U.S.-Russia [hereinafter Russia-U.S. Income Tax Treaty], *reprinted in* [Apr. 1993] 3 Tax Treaties (CCH) ¶ 10,660. This proposed treaty was signed on the occasion of President Yeltsin's visit with President Bush in Washington, D.C. This proposed treaty replaced the income tax treaty dated June 20, 1973 between the U.S.S.R. and the United States. *See* Convention for the Avoidance of Double Taxation, June 20, 1973, U.S.-U.S.S.R. [hereinafter U.S.S.R.-U.S. Income Tax Treaty], *reprinted in* [Apr. 1993] 3 Tax Treaties (CCH) ¶ 10,603. From the inception of the existence of the Russian Federation, the old U.S.S.R.-U.S. treaty was deemed to be applicable to Russian-U.S. transactions. However, because that treaty was both incomplete and outmoded, a revised treaty was promptly implemented after the emergence of the Russian Federation as an independent state. The President's September 8, 1992 transmittal message to the U.S. Senate concerning this treaty indicated that this convention "will modernize tax relations between the two countries and will facilitate greater private sector United States investment in Russia." Letter of Transmittal from President George Bush to the U.S. Senate (Sept. 8, 1992), *available in* LEXIS, Fedtax Library, TNI File, at 92 TNI 57-18 [hereinafter President's Transmittal Letter]. Similarly, the accompanying August 25, 1992 Letter of Submittal from the U.S. Department of State indicated: "It is hoped and expected that the new Convention will be an important impetus to Russia's emergence as a market economy by encouraging and facilitating greater United States private sector investment in Russia. The Convention will establish a framework which we hope will contribute to the expansion of economic relations between the two countries on a broader and reciprocal basis." Letter of Submittal from Arnold Kanter, Acting Secretary of State, to President George Bush (Aug. 25, 1992), *available in* LEXIS, Fedtax Library, TNI File, at 92 TNI 57-18 [hereinafter Secretary's Submittal Letter].

This new income tax treaty is based on a relatively standardized type of income tax treaty including provisions implemented between market economy countries with highly developed economies.⁴⁴ The treaty has been approved by the Russian side and is awaiting action by the U.S. Senate.⁴⁵ Other income tax treaties are currently being negotiated by the Russian Federation.⁴⁶

44. See, e.g., ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, MODEL TAX CONVENTION ON INCOME AND CAPITAL (1992) [hereinafter OECD MODEL INCOME TAX TREATY]. Released in September 1992, the OECD Model Income Tax Treaty is an example of a format for an income tax treaty between governments having highly developed economies.

45. For coverage of the proposed Russia-U.S. Income Tax Treaty, see John Turro, *Tax Treaty: New U.S.-Russia Income Tax Treaty and Protocol Examined*, 4 TAX NOTES INT'L 1339 (1992); Jeffrey M. Trinklein, *Tax Treaties: The U.S.-Russia Tax Treaty: Has the Foreign Tax Credit Been Resolved?*, 5 TAX NOTES INT'L 699 (1992) [hereinafter Trinklein, *Foreign Tax Credit*]. The U.S. Senate is scheduled to consider the proposed treaty during the Fall, 1993. See Sen. Hank Brown, *United States: Brown Advises Reassessment of Russia-U.S. Tax Treaty*, 6 TAX NOTES INT'L 920 (1993).

46. Poland signed a tax treaty with Russia on May 22, 1993. Janusz Fiszer, *Poland: 1992 Year in Review*, Tax Notes Int'l (Daily Serv.), Jan. 5, 1993, available in LEXIS, Fedtax Library, TNI File, at 93 TNI 2-9. The United Kingdom is in the process of negotiating a tax convention with Russia. *Inland Revenue Offers Tax Treaty Update*, Tax Notes Int'l (Daily Serv.), Oct. 27, 1992, available in LEXIS, Fedtax Library, TNI File, at 92 TNI 58-12. In a March 3, 1992 circular letter, the German finance minister commented on questions regarding the future application of Germany's tax treaty with Russia. With respect to tax policies with Russia, the minister assumed that Russia is identical to the former Soviet Union. The Germans believe that there has merely been a change in the name of the state and its territorial sovereignty. Russia, therefore, has assumed all rights and duties of the treaties concluded by the Soviet Union, under the German point of view. Consequently, income tax treaty agreements made between Germany and the Soviet Union remain valid with respect to Russia. *Summaries of This Week's Important Tax Items*, Tax Notes Int'l (Daily Serv.), Apr. 22, 1992, available in LEXIS, Fedtax Library, TNI File, at 92 TNI 17-H (citing Rainer Prokisch and Michael Rodi, Ludwig-Maximilians-Universitat Munchen). In a June 10, 1992 circular letter, the Swiss Federal tax administration reported that, with respect to the Commonwealth of Independent States, the tax administration assumes that the tax treaty with the former USSR is applicable to Russia. *Switzerland: Tax Treaty Developments*, International Bureau of Fiscal Documentation Tax News Service, July 21, 1992, available in LEXIS, Fedtax Library, IBFD File. "It has been reported that the Governments of Singapore and Russia are reviewing a comprehensive double taxation treaty which is expected to be finalized shortly." *Tax Treaty Between Singapore and Russia*, International Bureau of Fiscal Documentation Tax News Service, May 22, 1992, available in LEXIS, Fedtax Library, IBFD File.

Before dealing with the attempted resolution of the "foreign tax credit" issue through the mechanism of this proposed Russia-U.S. income tax treaty, certain general parameters of this tax treaty must be described and understood. The proposed Russia-U.S. income tax convention⁴⁷ provides for the exemption from tax at source of interest and royalties when paid to a party resident in the other country.⁴⁸ Dividends would be subject to tax at source at a maximum rate of ten percent and would be reduced to five percent in the case of dividends paid by a subsidiary corporation in one country to its parent corporation in the other country.⁴⁹ For this purpose, that parent corporation status would exist where more than a ten percent ownership interest was held in the other country.⁵⁰ The five percent tax rate imposed at source would also apply to branch profits.⁵¹

Capital gains on assets other than real property would be taxable only in the country of residence of the person deriving the gain. Such gains are dealt with in the residual article on "other income" which provides for exclusive taxation of that income not effectively connected with a place of business in the other country at the residence of the owner.⁵² Gains with respect to real property may be taxed where the property is located.⁵³

Business profits are taxable in the other country only to the extent attributable to a "permanent establishment" in that country, and then only on a net basis with deductions for

47. For a more complete description of this treaty see Trinklein, *Foreign Tax Credit*, *supra* note 45.

48. Russia-U.S. Income Tax Treaty, *supra* note 43, arts. 11 and 12, *reprinted in* 3 Tax Treaties (CCH) ¶ 10,660.23 and ¶ 10,660.25.

49. *Id.* art. 10, *reprinted in* 3 Tax Treaties (CCH) ¶ 10,660.21. The Russian statutory rate on dividends is 15%, imposed at the source. *Id.*

50. *Id.* art. 10(2)(a), *reprinted in* 3 Tax Treaties (CCH) ¶ 10,660.21.

51. *Id.* art. 10(3), *reprinted in* 3 Tax Treaties (CCH) ¶ 10,660.21.

52. *Id.* art. 19, *reprinted in* 3 Tax Treaties (CCH) ¶ 10,660.39. *See also* Secretary's Submittal Letter, *supra* note 43.

53. Russia-U.S. Income Tax Treaty, *supra* note 43, art. 19(2), *reprinted in* 3 Tax Treaties (CCH) ¶ 10,660.39 (specifying that such income may be taxed in accordance with the domestic law of that other State). This approach is consistent with the international norm of allocating real property tax jurisdiction primarily to the situs, rather than to the residence (as is the situation with interest and royalties).

business expenses.⁵⁴ A "permanent establishment" is defined in the treaty in a manner consistent with the usual definition in a tax treaty between two OECD countries.⁵⁵ Under the treaty, if a construction site or drilling rig is maintained by a resident of one country in the other country for a period longer than eighteen months, the site or rig would constitute a "permanent establishment," and become subject to profits tax in the other country.⁵⁶

The Convention further provides conditions under which each country may tax income derived by individual residents of the other country from independent personal services or from services as employees which are rendered in the first country.⁵⁷ Rules are also provided for the taxation of pension income and social security benefits.⁵⁸ Special relief is granted to visiting students, trainees, and researchers.⁵⁹ The provision in the existing U.S.S.R.-U.S. income tax treaty of a two-year exemption for visiting teachers and journalists is not retained. However, any person who prefers the existing treaty may continue to have it applied in its entirety for one year after the new Convention enters into force.⁶⁰ Items of income not specifically dealt with may be taxed only in the country of residence.⁶¹

The benefits of the Convention are limited to residents of the two countries meeting certain standards. These standards are designed to prevent residents of third countries from inap-

54. *Id.* art. 6(1), reprinted in 3 Tax Treaties (CCH) ¶ 10,660.13.

55. *Id.* art. 5, reprinted in 3 Tax Treaties (CCH) ¶ 10,660.11. Note that at the Washington-based Tax Foundation's March 2, 1993 conference on Russian taxes, Sen. Hank Brown, R-Colo., a member of the Senate Foreign Relations Committee (which committee will consider the proposed U.S.-Russia income tax treaty), told the group that "the treaty may already need an amending protocol." John Turro, *In This Issue*, Tax Notes Int'l (Daily Serv.), Mar. 15, 1993, available in LEXIS, Fedtax Library, TNI File, at 92 TNI 49-10. Sen. Brown recommended extending the treaty's permanent establishment provision. A Treasury official at the conference agreed that the current 12-month permanent establishment period should be extended, but not to the suggested 36 months. *Id.*

56. Russia-U.S. Income Tax Treaty, *supra* note 43, art. 5(3), reprinted in 3 Tax Treaties (CCH) ¶ 10,660.11.

57. *Id.* arts. 13, 14, reprinted in 3 Tax Treaties (CCH) ¶¶ 10,660.27, 10,660.29.

58. *Id.* art. 17, reprinted in 3 Tax Treaties (CCH) ¶ 10,660.35.

59. *Id.* art. 18, reprinted in 3 Tax Treaties (CCH) ¶ 10,660.37.

60. *Id.* art. 27(4), reprinted in 3 Tax Treaties (CCH) ¶ 10,660.55.

61. *Id.* art. 19(1), reprinted in 3 Tax Treaties (CCH) ¶ 10,660.39.

propriately using the Convention.⁶² Similar standards are found in other recent United States income tax conventions.⁶³

The proposed convention seeks to ensure that the residence country will avoid double taxation of income which arises in the other country and has been taxed there in accordance with the treaty's provisions.⁶⁴ The treaty also includes standard administrative provisions which will permit the tax authorities of the two countries to cooperate so as to resolve issues of potential double taxation⁶⁵ and, further, to exchange information relevant to implementing the convention and for identifying the domestic laws imposing the taxes covered by the convention.⁶⁶ The non-discrimination provisions go beyond the standard provisions in many income tax treaties by including assurances of non-discriminatory tax treatment with respect to residents of third countries as well as residents of the taxing state.⁶⁷

The convention will enter into force on the date of the exchange of instruments of ratification.⁶⁸ The provisions concerning taxes on dividends, interest, and royalties are to take effect on the first day of the second month following the exchange of instruments of ratification.⁶⁹ Provisions concerning other taxes will take effect for taxable years beginning on or after January 1 following the exchange of instruments of ratification.⁷⁰ Upon entry into force of the Convention, the 1973 U.S.S.R.-U.S. income tax treaty will cease to have effect between the United States and the Russian Federation.⁷¹ As

62. *Id.* art. 20, reprinted in 3 Tax Treaties (CCH) ¶ 10,660.41 (specifying the provisions of a "Limitation on Benefits" article).

63. See Convention for the Avoidance of Double Taxation, Dec. 18, 1992, U.S.-Neth., art. 26, reprinted in [Apr. 1993] 3 Tax Treaties (CCH) ¶ 6103; Convention for the Avoidance of Double Taxation, Aug. 21, 1989, U.S.-F.R.G., art. 28 [hereinafter German-U.S. Income Tax Treaty], reprinted in [Apr. 1993] 2 Tax Treaties (CCH) ¶ 3249; Convention for the Avoidance of Double Taxation, Sept. 18, 1992, U.S.-Mex., art. 17, reprinted in [Apr. 1993] 2 Tax Treaties (CCH) ¶ 5903. See William P. Streng, "Treaty Shopping"—Tax Treaty "Limitation of Benefits" Issues, 15 HOUS. J. INT'L L. 1 (1993).

64. See Russia-U.S. Income Tax Treaty, *supra* note 43, art. 22, reprinted in 3 Tax Treaties (CCH) ¶ 10,660.45 (providing for relief from double taxation).

65. *Id.* art. 24, reprinted in 3 Tax Treaties (CCH) ¶ 10,660.49.

66. *Id.* art. 25, reprinted in 3 Tax Treaties (CCH) ¶ 10,660.51.

67. *Id.* art. 23(1), reprinted in 3 Tax Treaties (CCH) ¶ 10,660.47.

68. *Id.* art. 27(2), reprinted in 3 Tax Treaties (CCH) ¶ 10,660.55.

69. *Id.* art. 27(2)(a), reprinted in 3 Tax Treaties (CCH) ¶ 10,660.55.

70. *Id.* art. 27(2)(b), reprinted in 3 Tax Treaties (CCH) ¶ 10,660.55.

71. That treaty may have continuing effect with other members of the

noted above, a taxpayer may elect, however, to apply the 1973 treaty in full for one additional taxable year after effectiveness of the new treaty if the provisions of the old treaty are more favorable.⁷²

2. The Accompanying Tax Treaty Protocol

A Protocol accompanies the proposed Russia-U.S. Income Tax Treaty and forms an integral part of this treaty. This Protocol clarifies the operation of certain provisions of the treaty and, also, denies treaty benefits with respect to dividends and interest paid by certain United States investment companies.

Most significantly, this protocol guarantees the deductibility of wage costs and interest expense (that might not otherwise be deductible under Russian domestic tax law) to (1) permanent establishments in Russia of United States residents and (2) Russian entities owned at least thirty percent by United States residents and having total corporate capital of at least U.S. \$100,000.⁷³ In such cases, the rate on the deductible interest is subject, however, to certain limits, and the taxpayer may not apply any reduced income tax rate applicable to taxpayers not claiming such deductions.

The Protocol to the treaty is unusual in that Russia has made treaty concessions not just to U.S. investors, but also to Russian entities that are owned by U.S. investors.⁷⁴ The Protocol provides that a Russian company with capital of at least U.S. \$100,000⁷⁵ that is owned at least thirty percent by a U.S.

former USSR (i.e., other country members of the present Commonwealth of Independent States) who have not entered into separate income tax treaties with the United States.

72. Russia-U.S. Income Tax Treaty, *supra* note 43, art. 27(4), reprinted in 3 Tax Treaties (CCH) ¶ 10,660.55.

73. See Secretary's Submittal Letter, *supra* note 43. This letter was prepared for transmittal of the Russia-U.S. Income Tax Treaty to the U.S. Senate for ratification. This modification is apparently to assure that the Russian profits tax qualifies as an income tax for foreign tax credit purposes under Treas. Reg. § 1.901-2 (1992).

74. The right to compute tax with all available deductions apparently extends to the Russian entity's entire profit, including the portion accruing to non-U.S. participants, e.g., Russian investors.

75. Protocol Regarding the Russia-U.S. Income Tax Treaty, para. 8(b) [hereinafter Protocol], reprinted in [Apr. 1993] 3 Tax Treaties (CCH) ¶ 10,661 (specifying that the capital requirement of U.S. \$100,000 "or the equivalent val-

resident (a "qualified Russian entity") will be entitled to a deduction in Russia for all "reasonable" interest payments and for all actual wage payments.⁷⁶ Normally, Russian domestic tax law severely restricts these deductions.

The Protocol to the treaty provides that any qualified Russian entity, and any permanent establishment in the banking, insurance, or other financial business can continue to calculate its tax as provided under the existing profits tax, regardless of any Russian domestic tax law changes.⁷⁷ This concession insulates U.S. investors from future Russian tax legislative instability.⁷⁸

Qualified Russian entities can be as much as seventy percent owned by investors from countries other than the United States (including Russia) and still benefit from the Russia-U.S. Income Tax Treaty protections of full interest and wage deductions and protections against changes in the tax law. In this way, those foreign investors who have U.S. joint venture partners should be entitled to benefit from the treaty.⁷⁹

ue in rubles"). With the continuing hyperinflation the question could arise concerning the time at which that "ruble" value is to be measured for this purpose.

76. *Id.* (regarding art. 22 of the proposed Russia-U.S. Income Tax Treaty). The protocol allows the interest deduction to be limited under Russian law to the London Inter-Bank Offered Rate (LIBOR), plus a reasonable risk premium. *Id.*

77. *Id.* ¶¶ 8(b) and (c), *reprinted in 3 Tax Treaties (CCH) ¶ 10,661.*

78. The University of Houston's Tax and Fiscal group regularly suggested to the Russian representatives the necessity of having a "tax stability" clause in tax legislation applicable to foreign investors.

79. Protocol, *supra* note 75, para. 8(b), *reprinted in 3 Tax Treaties (CCH) ¶ 10,661.* The treaty contains a comprehensive limitation on benefits article (article 20), which arguably supports the position that a non-U.S. or non-Russian shareholder of a qualified Russian entity should not be entitled to the benefits of the qualified Russian entity regime created in the protocol. It is difficult, however, to find a convincing rationale for this position. First, this position supposes that the treaty benefit here is the right to enjoy the fruits of the special tax regime for qualified Russian entities. It is perhaps more accurate to define the treaty "benefit" to a U.S. shareholder in this case as the right to endow a 30% Russian subsidiary with the special status of a qualified Russian entity. The presence of a German (for example) joint venture partner should not be viewed as violating the limitation on benefits article, since a shareholder from Germany could not endow the Russian entity with this special status.

Second, the language of the protocol does not support this position. The protocol requires only U.S. beneficial ownership of 30% of the entity. There is no requirement that the rest be owned by U.S. or Russian investors.

The Protocol specifies that, if the profits tax is no longer effective, a treaty-qualified entity may continue to compute its tax in the manner stipulated by that law, with the tax treaty modifications. The applicable tax rate would presumably be thirty-two percent.

3. *Explanatory "Technical Memorandum"*

A "Technical Memorandum" explaining in detail the provisions of the Convention is to be prepared by the U.S. Department of the Treasury and is to be submitted separately to the U.S. Senate Committee on Foreign Relations.⁸⁰ That memorandum should presumably further identify the elements of the additional deductions made available under the Protocol, and their effects for U.S. income tax purposes, particularly in determining the foreign tax credit issue.

G. *Are the Foreign Tax Creditability Problems Solved by the Tax Treaty?*

Neither the Russia-U.S. Income Tax Treaty nor the accompanying Protocol explicitly indicates that the Russian income taxes are creditable for purposes of the U.S. income tax foreign tax credit provisions.⁸¹ Technical questions still remain until

Third, it is unclear how Russian law would implement such a position. The position envisions a Russian entity, where 30% of its profits are taxed under the treaty regime and 70% are taxed under the normal profits tax provisions. Essentially, this requires flow-through partnership treatment for an entity that is taxed in Russia on its entity-level profits. See Trinklein, *Foreign Tax Credit*, *supra* note 45, at 700.

80. The U.S. Department of the Treasury often issues an accompanying "Technical Memorandum" or "Memorandum of Understanding" to explain its perspective (derived from tax treaty negotiations) with respect to the meaning and interpretation of various provisions in that treaty. In some situations the other country may agree to accept that memorandum or may issue its own memorandum of understanding. The Technical Memorandum for the Russia-U.S. Income Tax Treaty has not been released as of June 1, 1993, presumably due primarily to the Clinton Administration transition. However, the issuance of such a memorandum is often a prerequisite to the treaty "advice and consent" process of the U.S. Senate Foreign Relations Committee (anticipated to occur during the Fall, 1993).

81. Some U.S. double tax treaties specifically provide that foreign taxes covered by the treaty qualify for the foreign tax credit. See, e.g., German-U.S. Income Tax Treaty, *supra* note 63, art. 23(1), reprinted in 2 Tax Treaties (CCH) ¶ 3249.47; Convention for the Avoidance of Double Taxation, Dec. 31, 1975, U.S.-U.K., art. 23(1), reprinted in [Apr. 193] 3 Tax Treaties (CCH) ¶ 10,903.47.

the Internal Revenue Service formalizes its acceptance of such a position.⁸² However, the practical environment of this issue suggests that it has been resolved.⁸³ Many international tax specialists, including the author, would not be prepared to issue an opinion to this effect (except as to probabilities of success on this issue), even as based on the current record.⁸⁴ Consider, for

However, the U.S. Senate has indicated its displeasure concerning attempts to "stretch" a non-creditable tax into a creditable tax through an income tax treaty provision. For example, in its review of the proposed Denmark-U.S. Income Tax Treaty, the U.S. Senate has rejected the idea of tax credibility for the Danish hydrocarbons tax. See Convention for the Avoidance of Double Taxation, June 17, 1980, U.S.-Den., art. 23(1), reprinted in [Apr. 1993] 1 Tax Treaties (CCH) ¶ 2603.24; SENATE FOREIGN RELATIONS COMMITTEE, REPORT ON THE DENMARK-U.S. INCOME TAX TREATY AND PROTOCOL, sec. VI (Committee Comments), reprinted in [Apr. 1993] 1 Tax Treaties (CCH) ¶ 2650.

82. Letter from John E. Robson, Deputy Secretary of the Treasury, to Mr. Dan Witt, Executive Director, Tax Foundation (Nov. 2, 1992) (copy on file with the author). Deputy Secretary Robson indicated that:

One of the key issues in the negotiation of the proposed treaty was concern by both sides about the creditability of the Russian profits tax. To address those concerns, Russia agreed to make significant modifications of the tax base. Although the treaty does not provide an independent credit for the tax as modified, its effect is to make the tax a 'separate levy' for purposes of the U.S. foreign tax credit. At this time, the Internal Revenue Service has not formally reviewed the tax for creditability. However, the negotiators intended the modifications to satisfy the U.S. standards of a tax on net gain and thus to make it eligible for the credit.

Id. This letter obviously does not say that the tax is creditable, and the author of the letter did not have the authority to bind the Internal Revenue Service on this issue.

83. "A lingering question about the treaty is whether it allows U.S. treaty beneficiaries to claim a U.S. foreign tax credit for their Russian profits tax payments." John Turro, *Tax Treaties: Update of U.S. Tax Treaty Developments*, 5 TAX NOTES INT'L 1369, 1370 [hereinafter Turro, *Tax Treaty Update*]; see also Trinklein, *Foreign Tax Credit*, *supra* note 45, at 699 (discussing this issue). "On December 8, 1992, a U.S. Treasury official told a World Trade Institute conference that the special profits tax regime under the treaty was intended to be a creditable tax." Turro, *Tax Treaty Update*, *supra*, at 1370. Noting the concern that the IRS will not treat this special regime as a separate levy for foreign tax credit purposes, the IRS official said taxpayers need not be concerned about this issue. *Id.*

According to Acting Deputy International Tax Counsel Carol Doran Klein, the point of the treaty provisions that allow certain treaty beneficiaries to claim deductions otherwise not allowed under the profits tax law was to make the Russian tax creditable for those treaty beneficiaries. It would not make sense for the government to negotiate such changes and not permit the credit, she said. Klein added that this issue will be clarified during the ratification process.

Id.

84. Another example of hesitancy on this point is noted from the remarks

example, how quickly foreign political climates can change and the position of the Executive Branch is reversed.⁸⁵

A further technical question does remain if the applicability of the eighteen percent tax (which does not permit wage deductions) might produce a lower effective tax than the thirty-two percent tax (which, under the treaty Protocol, permits the employee wage deductions). If the treaty based profits tax exceeds the amount of income tax determined under the regular domestic law, the question then arises whether the excess amount paid is really a "compulsory payment" of a tax.⁸⁶ This type of approach would necessitate requiring the foreign venture taxpayer to annually compute its tax liability under both the thirty-two percent treaty-based profits tax and the eighteen percent income tax to determine if some portion is not creditable.

H. Present Alternative Entity Structuring Options

The assumption in the discussion above is that a U.S. company investing into Russia will organize either a special purpose U.S. subsidiary for this purpose or, alternatively, will organize an appropriate Russian company for this purpose, in either context having the availability of the benefits of the Russia-U.S. Income Tax Treaty. However, that treaty is not currently effective. Presumably, the present political climate will dictate ratification of the proposed treaty by the United States during the Fall, 1993, but modifications desired by the U.S. Senate Foreign Relations Committee members may significantly postpone this occurrence.

of Marcia Field, one of the U.S. Treasury negotiators of the Russia-U.S. income tax treaty, quoted as noting that the U.S. foreign tax credit regulations "support the treaty-modified tax being treated as a separate levy." John Turro, *Tax Treaties: Washington Tax Foundation Meeting Focuses on U.S.-Russia Tax Developments*, 6 TAX NOTES INT'L 642, 642 (1993).

85. If any proposed Iraqi-U.S. Income Tax Treaty (with a similar accompanying protocol) had been negotiated before the Gulf War would such an interpretation remain extant?

86. See Treas. Reg. § 1.901-2(a)(2)(i) & (e)(5) (1992) indicating that the amount of foreign tax credit is limited to the amount of tax which is required to be paid under foreign law. On various occasions, the IRS has asserted that payments to a foreign government are not actually a tax, but merely a voluntary payment (because refund remedies were not pursued) or a deductible payment equivalent to a royalty.

Business transactions must proceed and many investors cannot wait for the expiration of the usual lethargic process in the U.S. Senate for the approval of income tax conventions including, in this context, the Russian-U.S. income tax convention.⁸⁷ Therefore, many U.S. (and other non-Russian) investors have invested into Russia through a special purpose entity organized, for example, either in Cyprus or Austria. This has occurred, for example, because of an existing, favorable income tax treaty previously entered into by the former Soviet Union with Cyprus.⁸⁸ Under the U.S.S.R.-Cyprus treaty,⁸⁹ no tax is imposed at source on royalties,⁹⁰ dividends,⁹¹ or interest.⁹² The continued applicability of the Cyprus treaty has been recognized by representatives of the Russian Federation.

Notwithstanding the significant benefits under this treaty, some large U.S. enterprises have determined that the use of such a conduit approach is not politically appropriate, even though fiscally generous. Those U.S. enterprises feel that the benefits of the Cyprus treaty are too advantageous and, accordingly, ultimately, Russia will recoil from the continued availability of these benefits and move to rescind or renegotiate this treaty. This could take the form of implementing a "limitation of benefits" concept similar to that being incorporated by the United States in its recently negotiated income tax treaties. Certainly, Russia is not yet in the posture of renegotiating treaties to achieve this objective, but recent Russian economic history has produced many surprises.

V. THE VALUE ADDED TAX

The Russian Federation has enacted a value added tax (VAT), imposed at the rate (effective during 1993) of twenty percent, as one of its arsenal of tax collection weapons.⁹³ How-

87. As noted above, this approval process is complicated by the U.S. Treasury Department's preparation of a Technical Memorandum concerning this treaty, and Treasury's preparation of this memorandum is dependent upon the Clinton Administration having the workers and policy makers to complete this task.

88. See Trinklein, *Foreign Tax Credit*, *supra* note 45, at 705.

89. Convention for the Avoidance of Double Taxation, Oct. 29, 1982, Cyprus-U.S.S.R., available in LEXIS, Fedtax Library, TNI File, at 93 TNI 37-17.

90. *Id.* art. 6(1).

91. *Id.* art. 7(1).

92. *Id.* art. 8(1).

93. Law of the RSFSR Concerning Value Added Tax, Dec. 6, 1991, (Draft

ever, as noted below, the VAT provisions specify an exemption from VAT on the export of goods (work and services).

Previously, a sales tax was applicable in Russia. Commencing in 1992, the tax was renamed to be a "value added tax."⁹⁴ The tax has been applicable at the rate of twenty-eight percent, but this rate was reduced to twenty percent, effective as of January 1, 1993.⁹⁵ Application of the tax remains controversial.⁹⁶

The tax base for the sales of goods (identified in Article 3 of the VAT law) includes the turnover from the sales of all goods, including the turnover from the sales of goods, work, and services for foreign currency on the territory of the Russian Federation. The tax is applicable to many types of services, including receipts from the leasing of property.

An exemption is available for export transactions. Particularly, the VAT provisions specify that the export of goods (work and services) shall be exempt from the value added tax.⁹⁷ Presumably each international energy company will want to assure this result in its concession agreement.

We were not able to clarify with our Russian counterparts whether, prior to export, a value added tax might be imposed on petroleum products at some point in the distribution chain. We have noted that "when goods are exported the amounts of tax previously paid on their sale shall be refundable."⁹⁸ We

with account taken of Amendments introduced on Nov. 18, 1991) [hereinafter Value Added Tax Law], reprinted in Ernst & Young, *supra* note 10. Although Article 6 of this law originally indicated that the rate was 20%, the rate was thereafter changed to 28%, subject to being reduced at a later date. *Id.* art. 6.

94. *Id.*

95. Ayers, *Major Changes to VAT*, *supra* note 40, at 175.

96. Chairman of the Russian Parliament Ruslan Khasbulatov has commented "that he and the Parliament had made a big mistake in 1991 when they approved the 28-percent VAT, . . . one of the main causes of the inflation and economic distress that have beset Russia." *Russian Parliament Chairman Calls VAT a Mistake*, Tax Notes Int'l (Daily Serv.), Jan. 6, 1993, available in LEXIS, Fedtax Library, TNI File, at 93 TNI 3-16 (citing *Says Value Added Tax "Major Mistake"*, F.B.I.S., Dec. 16, 1992, at 31; Moscow INTERFAX, Dec. 15, 1992).

97. Value Added Tax Law, *supra* note 93, art. 7(1). See also *id.* art. 7(2)(a) (indicating that an exemption is available for the issue, concession, and receipt of patents, copyrights, and "licenses").

98. *Id.* art. 10. Note, also, that this VAT article specifies that a sale shall be considered to have been completed the moment that funds are received into bank accounts for goods (work and services) or, in the case of cash settlements, the day that the cash is received. Other procedures for defining the moment of

emphasized to our Russian counterparts that, for the exemption to really be available, any refund system (to recognize the VAT exemption for exports) must function promptly and efficiently. Any significant VAT refund delays will effectively constitute a tax to the extent of the interim use of the funds, i.e., the "time value of money."

One significant problem of the Russian VAT system is that the value added tax provisions do not include a credit for capital investment, i.e., an "input credit" on capital goods.⁹⁹ Western European countries all provide in their value added tax systems for such a credit and, accordingly, this lack of a credit under the Russian system could cause a substantial competitive disadvantage. The ordinary objective is to have no imbedded cost of VAT in exported capital goods. Since the VAT is included in the purchase price of capital assets that purchase price may be recovered through tax depreciation.

The VAT legislation has been subject, as noted, to substantial changes so as to respond to immense criticism.¹⁰⁰ Effective on January 1, 1993, imported goods, which previously were exempt from VAT upon importation, are subject to VAT as of the time entering into Russia.¹⁰¹ The VAT is charged on the full value of the goods, including all import and excise taxes due under other provisions of the Russian tax system. Consequently, under this tax computational mechanism the VAT on imports also constitutes a tax on other Russian taxes.¹⁰² Ser-

completion of a sale may be applied by agreement with the tax authorities.

99. However, assets imported by a foreign investor as part of its capital contribution to a Russian enterprise are exempt from VAT, customs duties, and excise taxes if the capital contribution is provided for in the enterprise's charter documents. See David M. Ayers, *Russian Federation Clarifies VAT on Imported Goods*, 6 TAX NOTES INT'L 517 (1993) [hereinafter Ayers, *VAT on Imported Goods*].

100. When Russia's Ministry of Finance released its final budget proposal for 1993 the government planned to divide the VAT into three subgroups, according to the nature of the goods involved. It planned to lower VAT rates on most goods from 28% to 20% and on food to 10%. However, the government proposed increasing the VAT on oil, natural gas, cars, and luxury items to 30%. *Russia's Finance Ministry Proposes Tax Law Changes*, Tax Notes Int'l (Daily Serv.), Nov. 27, 1992, available in LEXIS, Fedtax Library, TNI File, at 92 TNI 79-2 (citing *Final Draft of 1993 Budget*, F.B.I.S., Nov. 12, 1992, at 13-14).

101. Ayers, *Major Changes to VAT*, *supra* note 40, at 174 (indicating that certain imports, including some food products, medicines and medical devices, and scientific instruments are exempt from the tax or provided other privileges).

102. Ayers, *VAT on Imported Goods*, *supra* note 99, at 517. This article

vices of third parties in connection with obtaining patents and licensing technology are also subject to VAT.

The administrative/collection function for the VAT has been less than effective.¹⁰³ Although the VAT is generally perceived as one of the most effective taxes to administer (because of the limited locations of collection responsibility), this is not yet occurring in Russia.

VI. OIL EXPORT TAX

A controversial export tax has been imposed on the export of petroleum from the Russian Federation (at least when exported in a sale for hard currency).¹⁰⁴ The financial impact

presents an example: A foreign automobile having a customs value of U.S. \$10,000 will have a price of approximately U.S. \$18,180 when it clears Russian customs. This includes a duty of 25%, an excise tax of 25%, and customs documentation charges of 1.5%, all of which are subject to an additional 20% VAT charge. *Id.*

103. *Russian Finance Minister Refines Budget Expenditure to Reflect Additional Revenues*, Tax Notes Int'l (Daily Serv.), Jan. 13, 1993, available in LEXIS, Fedtax Library, TNI File, at 93 TNI 8-9 (citing *Finance Minister Speaks on 1992 Budget*, F.B.I.S., Dec. 18, 1992, at 51; Moscow Russian Television Network (Dec. 16, 1992)).

I should dwell particularly on value-added tax [VAT]. According to estimates, the real income base for this tax is of the order of R2.2 billion, mainly thanks to the high rate of absolute increase in profits and wages funds. But the nonpayments in the national economy, which are increasing month by month, and by 1 November already exceeded R3 billion, again influenced the reduction in the rate of VAT receipts. Another influence was the considerable lag between production and marketing of products. According to our estimates, 12-15% of VAT falls under nonpayments. The steps being taken together with the Central Bank to sort out the nonpayments will only take effect in January 1993, as far as one can see. For that reason, we estimate the revenue from VAT at almost R1.9 billion. To take the proposals of the committees and commissions of the Supreme Soviet into account, we should have gained R2.452 billion.

Finance Minister Vasily Vasilyevich Barchuk, Address at the Russian Federation Supreme Soviet Session in Moscow (Dec. 1, 1992) (recorded from the "Today at the Russian Federation Supreme Soviet" Program), *transcribed and translated in Russian Finance Minister Refines Budget Expenditure to Reflect Additional Revenues, supra.*

104. See Decree No. 7 of the Government of the RSFSR Concerning the Regulation of the Export of Oil and Oil Products from the RSFSR, Nov. 15, 1991 (on file with the author) (specifying that (1) the Ministry of Economics and Finance of the RSFSR shall specify export quotas and (2) the Ministry of Fuel and Power of the RSFSR shall control export licensing for oil and oil products. Russian representatives indicated that they are unclear concerning how this decree might be applicable to foreign investment projects).

of this tax can be significant.¹⁰⁵ The applicable tax rate has been changed, often without advance notice.¹⁰⁶ Some investors have been subjected to this tax after their investment arrangements into Russia have been finalized with an understanding that such a tax would be inapplicable to their Russian operations.

The objective of this tax is premised on the following economic justification: At the present time the world market price for petroleum is considerably higher than the Russian internal price. A burden should be imposed to partially discourage the export of oil (since those exports would be to the detriment of the Russian internal market), until the internal price comes closer to world market prices. The export tax would be gradually reduced as the difference between Russian domestic prices and world market prices narrow, until that world price equilibrium is established.

Various representations by Russian officials have been made that the tax would be removed in the near term. However, the tax was thereafter increased. Pending the purported elimination of this tax, one international energy company was rumored to have been stockpiling product until the suggested tax termination date. Thereafter, a decree of the Russian Council of Ministers was entered whereby certain joint ventures were exempted from this export duty. As of January 1, 1993, all joint ventures that are at least thirty percent foreign-owned are exempt from Russian export taxes on their production of petroleum, natural gas, and refined products, but only with respect to the amount produced in excess of the amount produced on the date that the joint venture company was formed.¹⁰⁷

This decree does not specify how to claim the exemption. Some foreign-owned joint ventures eligible for the prior exemption are still required to either pay the export duty or to post bank guarantees against the tax.¹⁰⁸ Apparently, the Russian Ministry of Fuel and Energy will establish quotas for duty-free exports of petroleum and national gas products.

105. See the chart at Appendix Two.

106. Previously the rate was 38 ECUs (European Currency Units, approximately U.S. \$49.4) per ton of oil exported. More recently, the tax is imposed at 30 ECUs per ton (or approximately U.S. \$36.00). See Appendix Two.

107. See Jeffrey M. Trinklein, *Russia Eases Export Duties on Oil and Gas*, 6 TAX NOTES INT'L 842 (1993).

108. *Id.*

VII. ROYALTY PAYMENT

A royalty payment will also be extracted under each petroleum production concession. The royalty percentage to be negotiated as of the inception of the license arrangement is anticipated in most situations to be in the ten to twelve percent range.¹⁰⁹ Royalties have depended to some extent on geographical location. Sliding scale royalties have occurred.

This percentage is to be determined by reference to the fair market value at the time of sale of the petroleum product. Under the negotiated concession agreement, the royalty payment might be required to be in cash or in kind.

During discussions with the University of Houston group, the Russian side debated whether sliding scale royalties should be made applicable, or only one stipulated percentage should be applicable for the life of the licensing arrangement. The impression is that the Russians want to continue to evolve towards variable royalties based on production and other factors and may have implemented such a concept in previously negotiated concession arrangements.

The imposition of a significant royalty responds to an intergovernmental problem within the Russian Federation. This royalty amount is to be allocated to various regional and local governments, while other taxes are entirely collected at the national level. The royalty, imposed on a gross rather than a net basis, also enables a more assured source of immediate funds for those local governments without regard to discussion concerning the appropriate allocation of expenses, overhead burdens (including foreign costs as being allocable), and various other factors.

VIII. WITHHOLDING TAXES

Distributions of profits, interest, and technical service fees to foreign owners and related parties will precipitate withholding taxes imposed at the source in Russia. The withholding

109. Letter from Ernst & Young to George Hardy (Dec. 2, 1991) (on file with the author) (indicating that royalties have been negotiable and have depended to some extent on geographical location and that sliding scale royalties have occurred). See WALLICH, *supra* note 11, at 104 (stating that royalty rates can range from 8% to 21%, depending on the profitability of petroleum fields).

rates identified in USSR income tax treaties will be recognized for this purpose, including the U.S.S.R.-U.S. Income Tax Treaty, until this treaty is effectively superseded by the proposed Russia-U.S. Income Tax Treaty.

The withholding rates specified in the existing and proposed tax treaties with the United States can be compared as follows:

	<i>U.S.S.R.-U.S. Treaty (existing treaty)</i>	<i>Russia-U.S. Treaty (proposed treaty)</i>
Dividends	no provision	5% or 15% (5% when 10% ownership exists)
Interest	0% ¹¹⁰	0%
Royalties (intangible properties, not mineral properties)	0% ¹¹¹	0%

IX. LICENSE FEES

Some amount of license fees will be paid at the time of the grant of the exploration and production license. The Russians were quite enamored of the idea that front-end fees should be charged, since the funds would then be immediately available. The University of Houston representatives continually emphasized that large front-end fees would impact dramatically upon the return on investment. The impact on the rate of return, since the additional funds were required to be invested at the inception of the project, could, we noted, constitute a significant discouraging factor on the anticipated investment decisions.

During our discussions we sought to particularly disabuse the Russians of the idea that multiple level license fees should be imposed at various stages of development of a field or specific well, as the existence and scope of petroleum resources becomes more clearly identifiable.¹¹² However, we are not

110. U.S.S.R.-U.S. Income Tax Treaty, *supra* note 43, art. III(1)(g), *reprinted in 3 Tax Treaties (CCH) ¶ 10,603.07.*

111. *Id.* art. III(1)(a), *reprinted in 3 Tax Treaties (CCH) ¶ 10,603.07.*

112. The World Bank report espouses a similar position. *See WALLICH, supra* note 11, at 106.

certain that this concept has been entirely abandoned. The seriousness of this perspective will, no doubt, be impacted by internal Russian politics and the evolving Russian political situation.

X. OTHER POTENTIAL FINANCIAL COSTS

A. *Other Governmental Charges Imposed*

A large variety of other financial charges are to be imposed on Russian based energy development projects.¹¹³ Since these other financial costs can significantly impact the economic viability of the Russian based foreign investment activity, many of these other possible economic costs are described in this segment. Other costs, not presently identified, will certainly arise in the context of particular negotiations, thereby necessitating a significant gross profit projection as a condition of a commitment to a Russian based petroleum project.

B. *Surrender of Foreign Currency Receipts.*

Enterprises located or registered in Russia may be required to sell a part of their foreign currency receipts to the Central Bank of the RSFSR "for the formation of the republican foreign currency reserve of the RSFSR."¹¹⁴ The norms for the compulsory sale of a part of enterprises' foreign currency receipts to the Central bank are to be prescribed by the Russian Government. Further, the Central Bank of Russia is to independently determine the exchange rate of the ruble as applied to the settlement of ruble payments for that part of enterprises' foreign currency receipts which is subject to compulsory sale.¹¹⁵ Of course, since the value of the ruble has been in a "free-fall," the establishment of such an exchange rate is dramatically difficult.

113. See, at Appendix Two, the cash flow chart identifying the multiple governmental charges, taxes and similar items which might be applicable.

114. Edict of the President of the Russian Soviet Federal Socialist Republic Concerning the Liberalization of Foreign Economic Activity in the RSFSR, Nov. 15, 1991, sec. 4 (on file with the author) (specifying that as of January 1, 1992 such rules are imposed).

115. Section 6 of that edict specifies that the ruble rates which are established by the State Bank of the (former) USSR are not applicable in the RSFSR. *Id.* sec. 6.

C. *Additional Payment to Fund RSFSR Petroleum Studies*

An additional payment to fund RSFSR petroleum surveys may be imposed, particularly as a result of negotiation of the license or concession agreement. The magnitude of this possible additional cost has not been presently ascertainable. Whether this has been negotiated into current concession agreements which have been finalized has not been ascertained.

D. *Environmental Taxes*

Various environmental taxes have been imposed.¹¹⁶ Additional taxes, and more rigorous enforcement, can be anticipated in this context, particularly when considering the immensity of the environmental problems existent in the Russian petroleum sector.¹¹⁷

116. See *Russia Seeks to Harness Market Forces to Clean Up Environment, Choosing Taxes Over Regulation*, Tax Notes Int'l (Daily Serv.), May 20, 1992, available in LEXIS, Fedtax Library, TNI File, at 92 TNI 21-H.

As part of its move toward a market system, Russia has created an elaborate system of environmental taxes, rejecting the command and control regulatory approaches common in the West. Konstantin Gofman told the Kennan Institute for Advanced Russian Studies Gofman, deputy director of the Russian Academy of Sciences' Institute for Market Studies, said, "Of all the countries in the world, it is now Russia that has the most developed system of pollution taxes. We have fees or taxes for most major types of air and water pollution and for solid waste disposal." . . . The environmental tax rates are set proportionally to the toxicity of the pollutants However, the level of the taxes, taken together, is set to generate the revenues necessary to fund environmental protection measures. The taxes differ from theoretically perfect environmental taxes in that there is no effort to equate the revenues to the total value of the environmental damage done

The environmental tax system is new and is still plagued by compliance and monitoring problems Enforcement is primarily local and different localities have been experimenting with different approaches. For instance, there are government spot checks of emissions levels as measured by government instruments and as recorded in company records. "If they differ for the day they are tested, the locality may assume the difference extends for the entire quarter." [Gorman] added that Russia has created special environmental prosecutors and that there are criminal penalties for deliberate falsification of environmental records.

Id.

117. WALLICH, *supra* note 11, at 105. The World Bank report notes that Russia should impose environmental taxes, but that they should be based on estimates of social costs—the cost of the transportation infrastructure, for example, or the increased health-care needs attributable to environmental degradation. "All such costs should be covered through the use of taxes, fees, and

XI. TRANSFER PRICING

The Russian tax representatives participating in the petroleum legislation project understand that significant leakage from their domestic tax base can occur under an aggressive or excessive "transfer pricing" structure implemented by a group of related companies, particularly those having cross-border transactions.¹¹⁸ This can occur, for example, because the Russian affiliate would charge an inadequate price for its product sold to a foreign (i.e., non-Russian) affiliate, or would agree to pay an excessive price for services rendered by an affiliated company, thereby resulting in excessive value being transferred out of the country under the guise of an arm's length business transaction.

One dilemma in this context has been that many Russian tax theoreticians initially had substantial difficulty in understanding how an arm's length pricing concept might be applied. This was understandable after recognizing that those individuals are themselves evolving from a system which has been able, without free market constraints, to mandate a pricing regime having little or no relevance to the allocation of real economic value among the parties to a transaction. However, the United States experience in attempting to delineate the economic allocations of income illustrates the immense difficulties in this context.¹¹⁹

Although ostensibly arising in the context of monitoring the activities of international companies investing into Russia, for the Russian Federation, this issue of transfer pricing arises in two distinct but equally important situations:

- (1) the pricing of arrangements between Russian based entities and their international counterparts; and
- (2) the pricing of transactions across borders of the countries within the Commonwealth of Independent

charges related as closely as possible to the social costs generated." *Id.*

118. Presumably, at least at the inception, we hope that the Russians will not be interested in the complexity of intercompany pricing rules such as are represented by the temporary transfer pricing regulations, as released by the IRS during January, 1993. Temp. Treas. Reg. § 8470 (1993) (interpreting I.R.C. § 482 (West Supp. 1993)).

119. See I.R.C. § 482 (1993).

States (even though the ruble might be retained as a common currency).¹²⁰

The anticipation is that the Russians will attempt to adopt processes for applying the international norm of the "arm's length standard." However, the paucity of tax administrative capabilities in Russia suggest that immense difficulty will arise in application.¹²¹

XII. "SUPERTAX"

A. *Applicable Concepts*

Significant sentiment apparently exists in some Russian government sectors for the imposition of a "supertax" or a "super-profit tax," to be applied to cash flow derived after the return of capital investment and some minimum profit.¹²² Some of the Russian delegation members discussing these matters with the University of Houston representatives emphasized that the Russian Federation does anticipate imposing some type of "supertax" to collect an additional amount of revenue after the international energy enterprise has retrieved its investment, plus some "uplift" factor.¹²³ However, other

120. See *Russia: Moscow and Minsk Reach Taxation Agreement*, Reuters, Jan. 12, 1993, available in LEXIS, Txtline Library, TXTLINE File. "The Russian Parliament has ratified the Taxation Policy Agreement between the Russian and Belarus Governments. The two states have pledged to preclude double taxation. A special agreement will determine a system of sharing revenues from railway, water and air transport, pipelines, power grids and communication lines." *Id.*

121. On anecdote in this context might suffice: When pointing out to our Russian colleagues that under the Russia-U.S. Income Tax Treaty "reasonable" allocations of non-Russian expenses could occur to offset Russian based income, they noted that a "reasonable" yardstick is not understood in Russian tax parlance.

122. Letter to (1) Mr. Gennady Kalistratov, Committee on Industry and Energy, Supreme Soviet of Russia; (2) Mr. Yury Sergeev, Sub-Committee on Natural Resources, Supreme Soviet of Russia; and (3) Mr. Sergey Shatalov, Sub-Committee on Taxation, Supreme Soviet of Russia from W.F. Threlfall, Vice President, Europe/CIS Business Unit, Exxon Exploration Company, Houston, Texas (Jan. 7, 1993) (written on behalf of an Interim Committee of a new petroleum industry association (to be known as the Petroleum Advisory Foundation) being formed with respect to Russia) (on file with author). This letter references a latest draft of petroleum legislation which includes a "special tax regime" (Article 59.3) and a "super-profit tax" (Article 63).

123. A reference source for this idea as periodically cited by the Russians was an article by Charles P. McPherson & Keith Palmer, *New Approaches to Profit Sharing in Developing Countries*, OIL & GAS J., June 25, 1984, at 119. This

reports indicate that many in the Supreme Soviet are not seriously considering such a concept, believing that significant international investment can only be encouraged by the opportunity afforded to international companies to share in substantial profit situations in Russia, particularly when investing in highly volatile political risk situations. Authorization for such a tax can reasonably be anticipated to be included in future legislation, but whether such a tax will be finally implemented in a manner having significant financial impact is a different issue.

The dilemma for Russia is that the mere debate of the issue is sufficient to cause such substantial concern among large international energy companies that they postpone from finally committing large investment to significant projects in Russia. The longer term complication will be that, even if such a tax is not adopted, or is adopted in a form which can be accepted from the financial perspective, the continuing instability about its enactment will postpone important investment decisions (particularly if other factors, such as political instability, compound these problems).

If enacted, this tax would presumably be included in a separate revenue tax law for natural resources. Some Russian representatives examining this concept regularly referred to the U.K. Petroleum Revenue Tax (PRT) as an example to be emulated in this context. University of Houston representatives regularly emphasized to the Russians that any such a tax must be considered in the context of the already sufficiently confused Russian tax system applicable to the energy sector, and that the United Kingdom presents a quite different political environment than that in Russia.¹²⁴

article identifies various countries where "rate of return based profit sharing" is used, particularly (1) Papua New Guinea; (2) Madagascar, (3) Guinea-Bissau, (4) Somalia, (5) Tanzania, (6) Equatorial Guinea, (7) Liberia, (8) Kenya, (9) Pakistan, and (10) Senegal. Presumably the subsequently enacted Australian Resources Rent Tax would also be relevant in this context.

124. Ironically, in a March 16, 1993 Budget Press Release the United Kingdom Inland Revenue noted that the Chancellor proposed reduction of the impact of the PRT. That news release identifies that "[t]he Chancellor's intention is to put in place a tax regime which will encourage the further development of the UK's oil and gas resources by allowing companies to keep more of the fruits of their efforts, whether from additional investment in existing oil and gas fields, from the development of new ones, or from technical innovation and other forms of cost-control; and which meets the needs of the smaller or less-

B. Necessity for a Defined Russian Federation Fiscal Regime

University of Houston representatives emphatically suggested (as did representatives of the World Bank), that the structure of a supertax should not be considered outside of the context of the full Russian fiscal and taxing regime. We noted that international energy firms will evaluate investment potential in Russian based on a project's overall profitability and the anticipated rate of return. Projections of anticipated company profitability are premised, we indicated, on both (1) the net effect of the total Russian "take" (of production and/or revenues); and (2) the timing of that "take". If royalties, license fees, production sharing, state participation, import levies, decelerated cost recovery, corporate income taxes, dividend withholding taxes, mandatory conversion of hard currency, export taxes, value added taxes, and other charges have all been enacted, the justification for an additional cash flow tax is difficult to explain.¹²⁵

C. International Risk Assessment

University of Houston representatives noted for their Russian counterparts who have been examining a "super-profit tax" that, for international energy companies, Russia must be considered to be a very high-risk country. Therefore, these energy companies need to have the opportunity to participate significantly on the up-side, to compensate for undertaking this substantial risk factor. We noted that the prevailing sentiment among the major international energy companies is one of caution regarding the investment climate in Russia, explaining that the oil business is a capital-intensive and high-risk industry.

We noted for the Russian representatives that most international energy company representatives operate in a capital-constrained environment, which means that more potentially

straightforward North Sea fields, and of innovative developments of existing fields, which are likely to be of increasing importance in the future." *Inland Revenue Issues Budget Press Release on Reform of North Sea Taxation*, Tax Notes Int'l (Daily Serv.), Apr.1, 1993, available in LEXIS, Fedtax Library, TNI File, at 93 TNI 62-24.

125. See Appendix Five, for an example of a cash flow tax structure in a hypothetical situation involving Russian oil production.

economic investment opportunities exist in the world than capital available to invest in petroleum development projects. Consequently, we observed, natural market forces have created an environment in which emerging oil and gas opportunities in countries such as Russia, Mexico, Venezuela, Eastern Europe, and others, must compete for international investment capital. Competition therefore occurs in the structuring by each country of its fiscal and contractual energy policy and, we noted, Russia must recognize the existence of this competition. Its representatives, we argued, cannot be deluded by the immensity of its petroleum resources as being such a "trump card" which enables a prohibitive taxing scheme.

Consequently, we argued, the incentive for investment, measured as the potential for generating profits, must be commensurate with the risk entailed by investing in each country. In Russia, the composite investment risk, we noted, is considered to be significant by independent experts regularly engaged in quantifying "country risk." Increasing stability in Russia could enhance this investment environment, thereby improving the investment environment, but declining political stability could produce significant doubt and delay among even the least cautious investors.

We commented that, in evaluating the "country risk" for potential large scale energy sector into Russia (particularly when examining a potential "supertax" regime), the composite country risk is measured by a variety of methods. Four types of risk are generally focused upon: technical, political, financial, and economic. Technical risks are often of the greatest magnitude in oil and gas evaluations, and these include concerns related to hydrocarbon sourcing, hydrocarbon migration, trap integrity, reservoir porosity and permeability, gas/oil ratios, reservoir drive mechanisms, quality of the crude product, project timing and logistics, availability of modern equipment, petroleum transportation, environmental issues, and a variety of other factors. Political risk evaluation relates primarily to expectations of political and social stability, including the risk of nationalization and force majeure events. Financial risk evaluation looks at the time and magnitude of projected investments, foreign currency exposure, and foreign exchange rate fluctuation forecasts. Economic risk measurement takes into account expectations concerning inflation in the country of investment (and the home country), oil and gas price forecasts,

petroleum supply and demand issues, and fiscal stability, for example.

Risk evaluations which we provided to the Russian representatives indicated that Russia ranks poorly in three of the four principal categories (with an exception for hydrocarbon risk).¹²⁶ These evaluations have not materially improved since those classifications were provided.

D. Tax Creditability or Deductibility of Supertax Payments

Any supertax would not be creditable as a foreign income tax for U.S. income tax purposes, thereby not effectively moderating the net financial impact of this tax. It might be deductible for purposes of computing the net U.S. income tax liability. This deduction would, in turn, reduce the effective cost of the Russian income tax. However, even with such a deduction, the Russian tax is anticipated to produce an excess foreign tax credit situation (with respect to the other Russian taxes imposed on the Russian energy project). In this context, the profits tax would not be the only creditable tax (and tax cost); the withholding taxes on dividends, for example, also being an effective cost in repatriating the Russian based income.

Averaging with petroleum activity tax costs in other jurisdictions might permit the effective utilization of these taxes paid. However, such averaging (because of the foreign tax credit "basket" system) often seems problematical.¹²⁷ Further, in any event, the net result in Russia would be an excessive tax regime, discouraging investment.

126. As evidence of these evaluations, the Russian representatives were provided with materials from several independent sources engaged in measuring "country risk." Excerpts from THE INTERNATIONAL COUNTRY RISK GUIDE, a worldwide ranking of countries, rank-ordered according to relative investment risk were provided. This list is compiled periodically by an independent international risk monitoring agency, Eurostudy, located in London. According to Eurostudy, recent events (late 1991 for purposes of this study) in Russia moved Russia's position within the ranking from a composite risk of 55.5 to one of 50.5, placing it even more unfavorably among other nations typically regarded as "high risk". This score was probably lowered because the risk of investment in Russia was perceived as increasing, not decreasing. Similar information was also provided, as excerpted from Frost & Sullivan's Political Risk Services (New York). See, at Appendix Three to this article, a more complete description of the process of country risk assessment.

127. See I.R.C. §§ 904, 907 (1988) (this latter section providing special foreign tax credit limitations rules with respect to foreign oil and gas income).

E. *Quantifying the Net Overall Tax Effect*

Unless some other very important intangible element is at stake, no manager of an international business enterprise can justify investment in an enterprise where the anticipated return is significantly less than market expectations. This is particularly the situation where substantial capital constraints exist. No matter how large the project and its the brightness of its long term prospects, even less incentive exists where the net return from a project is anticipated to be de minimis or even negative. This is the essence of the argument continuously being made to the Russian representatives engaged in developing a supertax regime.¹²⁸

XIII. SEPARATELY NEGOTIATED CONCESSION AGREEMENTS

A. *The Thrust Towards Separately Negotiated Agreements*

Although the framework of the generally applicable Russian taxation structure is described above, in individual contract situations involving specifically negotiated concession arrangements, different taxation rules might be specified.¹²⁹ For ex-

128. The World Bank report has strongly suggested to Russia that its tax system be tilted away from production based taxation in favor of a "rent-based" taxation (or, as perceived by the Russians, a supertax regime). WALLICH, *supra* note 11, at 106. The report notes that rent taxation is desirable because it does not affect decisions about investment, production techniques, or the timing and quantity of output. Most other forms of taxation, by comparison, such as severance taxes and royalties and property taxes do affect these decisions and can threaten the optimal exploitation of resources. The report observes that taxes and quasi-taxes based on production, rather than profits, appropriate more than half of the market value of exported oil, making it highly unlikely that any but the most productive fields could cover expenses and show a profit, even before profit tax. *Id.*

129. Alexander Pochinok, Chairman of the Standing Committee of the Supreme Soviet of the Russian Federation, said that Russia does not provide special tax holidays for profits earned locally by foreign investors. Previous tax holidays were abused, Pochinok said. He added, however, that his government is willing to deal with potential foreign investors one-on-one. He said that in considering a tax concession arrangement, Russia looks for businesses that will put "something concrete" on Russian territory. He stated however, that to date, there has not been any significant foreign investment in his country. See *Taxation of Foreign Investment in Central and Eastern Europe Explored at Joint TEI/United Nations Symposium*, Tax Notes Int'l (Daily Serv.), June 24, 1992, available in LEXIS, Fedtax Library, TNI File, at 92 TNI 26-12.

ample, the Foreign Investment Law specifies that "[c]oncession contracts can contain exceptions from the current legislation of the RSFSR. In this case they are subject to approval of the Supreme Soviet of the RSFSR."¹³⁰

The Proposed Petroleum Code of the RSFSR (as prepared by the UH Licensing Group) contemplates that a "Production Sharing License" might be entered into "under which Petroleum will be shared in kind between the Licensee and the Competent Authority" Article 6(c) of this Draft Code.¹³¹

The licensee under a production sharing license should certainly have the right to recover its costs and expenses incurred in conducting petroleum operations within the license area and receive remuneration for its investment, in the form of a share of the petroleum produced as a result of its petroleum operations in accordance with the terms and conditions set out in the license. However, no provision in the draft petroleum code specifies the contemplated taxation of such production sharing arrangements.

Presumably, the taxation of the production sharing arrangement would be subject to being negotiated in the context of a particular production sharing agreement. Alternatively, the licensee would be immunized from taxation because of the split of the revenues. However, even under such circumstances, various minor fees, tariffs and other items may be imposed and could constitute significant cost factors.

The normal anticipation is that a production sharing contract interest is subject to the normal levels of Russian taxation. However, a particular difficulty with separately negotiated production sharing agreements can be that each agreement becomes essentially its own separate taxation system. This is quite likely to occur even if a standardized concession agreement is adopted for regular usage when special financial arrangements are incorporated into what initially appears to be a standardized concession agreement.

This individuality of each concession arrangement mandates regular scrutiny by government authorities of each licensing agreement and the licensee's financial records to determine whether the government is receiving its appropriate amount of

130. Foreign Investment Law, art. 40.

131. See the discussion of concession agreements in Conine, *supra* note 2, at 324-39.

take. Each agreement will vary in some significant or insignificant element. From the perspective of the governmental agency monitoring this contract, this can cause extreme complexity.

Certainly, the better approach would be to have, to the extent possible, a nationally applicable taxation system, with variances only at the edges. Separately negotiated concession agreements (effectively constituting a substitute for a taxation regime) can be accommodated in those country situations where only a limited number of concessions will be granted, or when a uniform production sharing arrangement can be mandated. However, when considering the vast petroleum wealth, the geographical expanse in Russia, and the immense variety of petroleum extraction situations in Russia, this individual structuring of extensive concession arrangements can not really and ultimately be a workable situation in Russia. Further, the vast variety of accommodations to implement the desires of local governments will further complicate these production sharing regimes.

If this occurs on a large basis, as University of Houston representatives indicated to the Russian representatives, a capable tax administrative and enforcement system needs to be developed to monitor these arrangements on an even handed basis. Specialized expertise will be essential to understand the nuances of each concession agreement.

B. Will Separate Arrangements be Recognized on a Continuing Basis?

Even assuming that a separate production sharing has been implemented, with accompanying beneficial tax provisions to accommodate the Russian tax regime, what are the prospects for the continued recognition of those arrangements? This question must relate to the continued stability of each of these arrangements, notwithstanding political change. Obviously, only if the contract is to be recognized on a continuing basis should the investment commitment be made. This is really not an issue ultimately involving taxation. However, it is another factor encouraging a generally applicable tax system and a factor in dictating how the international energy company will address reaching a conclusion as to the minimum anticipated rate of return which is acceptable for a project.

The Supreme Soviet does have the authority to examine these independently negotiated arrangements. Serious concern

exists that some of these arrangements previously entered into may not be respected in the future.¹³²

C. *Tax Creditability for the Production Share*

The production share delivered to the government would not constitute an income tax which would be creditable for U.S. foreign tax credit purposes.¹³³ This position recognizes that the result of the concession agreement is really a payment for an allocation of resources, rather than a taxing arrangement.

XIV. THE IMPACT OF INFLATION ON THE TAXING PROCESS

A matter of particular concern to tax policy makers on the Russian side is the impact of inflation (or hyper-inflation?) on the recovery of invested cost and on the proper measurement of profit for taxation purposes.¹³⁴ Inflation accounting may be the most critical issue in this process of determining the allocation of revenues between the international investor and the government.

The Russians are clearly searching for a mechanism to assure that the impact of inflation is eliminated in guaranteeing the real economic return of investment, plus an "uplift" factor, as measured by reference to a convertible currency of the investor's home country, or some basket of convertible currencies. For international energy companies this could presumably be accomplished by permitting them to measure their return by reference to some external hard currency standard (for example, the currency of their residence country or the convertible currency otherwise received upon sale of product, perhaps translated into the currency of residence as of that time).

This concern also exists, however, for domestic (i.e., Russian) enterprises and international energy companies forming

132. At a November, 1992 conference in Houston, one Russian representative indicated that the Supreme Soviet was reviewing a specific concession agreement previously implemented.

133. Rev. Rul. 76-215, 1976-1 C.B. 194 (holding that I.R.C. § 903 (permitting an "in lieu of" credit) would not apply if a concession contract with a government (here the Indonesian Government) really charged a royalty for oil owned by Indonesia). See also Rev. Rul. 69-388, 1969-2 C.B. 154, modified by Rev. Rul. 76-215, and Rev. Rul. 78-410, 1978-2 C.B. 347.

134. Substantial information concerning adjustments for inflation were provided to Dr. Serghei Shatalov of the Supreme Soviet.

partnerships with those domestic companies that all parties must be cognizant of the demands of their partners that appropriate inflation adjustment mechanisms are available. Under such circumstances, the domestic investment capital amount would somehow need to be indexed for inflation. This, in turn, raises the issue of how any inflation adjustment factor can and should be mechanically determined and what the ancillary effects of those inflation adjustments into the Russian taxation system should be.

XV. EMPLOYEE TAXATION

A. *The Income Tax Applicable to Expatriates*

Russia has also sought to impose extraordinarily high taxes on wages of individuals (including foreigners) resident in Russia.¹³⁵ For this purpose the term "resident" includes foreigners resident in Russia for more than one-half of the year.¹³⁶ Therefore, international energy companies may indirectly bear a significant cost through increased employee expenditures.

Imposition of this individual income tax caused immense concern among international enterprises in Russia when it was introduced because the top marginal tax rate was initially set at sixty percent of worldwide income for Russian "residents."¹³⁷ After its adoption the sixty percent rate soon began to apply at income of about U.S. \$4,000 per year, due to the rapid decline in the value of the ruble against convertible currencies.¹³⁸ In response to numerous complaints, the top marginal rate was retroactively reduced in July, 1992 to forty percent, although little adjustment was made to the level at which the forty percent rate takes effect.¹³⁹

Russia's personal income tax rates have been reduced significantly for 1993. The Supreme Soviet has reduced the top rate of personal income tax from forty to thirty percent.¹⁴⁰

135. Jeffrey M. Trinklein, *Russia: 1992 Year in Review*, Tax Notes Int'l (Daily Serv.), Jan. 5, 1993, available in LEXIS, Fedtax Library, TNI File, at 93 TNI 2-6 [hereinafter Trinklein, *Year in Review*].

136. Russia-U.S. Income Tax Treaty, *supra* note 43, arts. 13 and 14, reprinted in 3 Tax Treaties (CCH) ¶ 10,660.27 and ¶ 10,660.29.

137. Trinklein, *Year in Review*, *supra* note 135.

138. *Id.*

139. *Id.*

140. *Id.*

This maximum rate applies to all income in excess of two million rubles per year. The top marginal rate of forty percent previously applied to all income in excess of 60,000 rubles per year. For most foreigners resident in Russia, the top rate applies to almost all income, since the benchmark of two million rubles equals only about \$2,000 at current (mid-1993) exchange rates.¹⁴¹

B. The Incentive for Tax "Planning"

This difficulty with respect to the individual income taxation of expatriates will cause the evolution of several customary international tax planning responses, some appropriate and some "less than appropriate." One obvious possibility is for the foreign individual to spend less than six months in Russia, thereby not being a "resident" for purposes of the worldwide application of the Russian individual income tax. The problem with this is that such a disjointed arrangement reduces the continuity of the foreign firm's representation in Russia, substantially reducing its effectiveness in the Russian marketplace.

Another mechanism in this environment is the use of a "split payroll" technique. Under such an arrangement, the foreign individual receives a quite significant part of his or her compensation outside of Russia and reports only that portion utilized in Russia. In some situations the payroll can be "split" with the individual rendering advisory or managerial services for a related company outside the country of residence, often accompanied by a favorable allocation of the revenue to the services rendered outside the country. This is a common technique used when the foreign based employee is in a country imposing personal taxation on a jurisdiction or geographical basis.

In a situation such as the taxation rules imposed by Russia on a worldwide basis, the use of a split payroll technique is, however, conspicuous avoidance of the applicable local tax rules. Some companies and their employees will be willing to take this

141. David M. Ayers, *Russia Reduces Top Marginal Personal Income Tax Rates*, 6 TAX NOTES INT'L 1042 (1993). In addition to reducing the top marginal tax rate, the Supreme Soviet has also significantly changed the parameters of the tax brackets for income taxed at the lower rates, principally to combat the effects of inflation. The changes were adopted on March 6, 1993, but are effective retroactive to January 1, 1993. *Id.* at 1042.

risk, recognizing the laxity of Russian tax administration. Others, particularly those having significant Russian based investment (or contemplating such investment), and having a large international image, certainly cannot do so and, therefore, must bear the additional cost. A more appropriate mechanism might be to treat amounts advanced as loans, rather than compensation, until a time when Russian "residence taxation" is no longer applicable.

C. *The Impact of the Russia-U.S. Income Tax Treaty*

The Russia-U.S. Income Tax Treaty contains a number of benefits for U.S. individuals working in Russia, partially ameliorating the difficulties described immediately above. When the treaty is effective, U.S. individuals will be entitled to protections similar to those available under most other income tax treaties to which the United States is a party. For instance, U.S. employees working in Russia for a U.S. employer for less than 183 days in any calendar year should be exempt from all Russian income tax.¹⁴² Further, and perhaps more importantly, U.S. taxpayers who are residents of Russia will be entitled to a credit in Russia for any U.S. income taxes paid.¹⁴³ However, these rules will not solve the real problem of probable excessive worldwide basis income taxation by Russia on U.S. individuals resident in Russia. This will, in turn, cause a gross-up of employee wages on a spiralling basis to accommodate the employee, thereby indirectly significantly increasing the employer's operating costs in Russia.

XVI. PROSPECTS FOR THE FUTURE

The evolution of the Russian taxation system as applicable both to international energy companies and to domestic energy sector investors in Russia is quite difficult to predict.¹⁴⁴ The

142. Russia-U.S. Income Tax Treaty, *supra* note 43, art. 14(2), reprinted in 3 Tax Treaties (CCH) ¶ 10,660.29.

143. *Id.* art. 22, reprinted in 3 Tax Treaties (CCH) ¶ 10,660.45. An increase in 1993 tax legislation for individuals, as suggested by President Clinton, would reduce this differentiation in income tax costs. On February 17, 1993, President Clinton proposed that the maximum individual tax rate be increased to 39.6%, thereby only a 0.4% tax rate differential existing between the U.S. rate and the then applicable 40% Russian rate. With the reduction of the Russian tax rate to 30%, an excess foreign tax credit problem should be eliminated.

144. *Russian Congress Issues Decree on Economic and Tax Reform*, Tax Notes

tax legislative process in the United States Congress is chaotic, but certain underlying premises concerning the working of a market system are generally understood.¹⁴⁵ In Russia the energy tax legislative situation is complicated by multiple factors:

- (1) A desperate need for immediate hard currency revenue;
- (2) A confused legislative process which is only beginning to function in a more rationalized process;
- (3) The inability to predict the economic results and tax collections to be derived from any particular tax legislative initiative;
- (4) Immense jealousy among various governmental factions;
- (5) Concern among domestic factions, including the large domestic production associations, that no excess

Int'l (Daily Serv.), Jan. 14, 1993, available in LEXIS, Fedtax Library, TNI File, at 93 TNI 9-4.

In mid-December 1992, the Congress of Russian Federation People's Deputies announced (in Decree No. 4047-1) economic reform measures to be taken by the Russian Federation government, the Russian Supreme Soviet, the Russian Federation Central Bank, and the Russian Federation president. Congress ordered the Federation government to introduce tax concessions and targeted bank credits to eliminate legal obstacles blocking investments. The decree calls on the Russian Federation Supreme Soviet to make changes to the Russian Federation law "on basic principles of the taxation system," giving the subjects of the Russian Federation the right to impose additional taxes to support social programs. In addition, the Supreme Soviet must introduce changes and additions to taxation and budget legislation taking into account the constitutional position of the Federation Treaty by April 1, 1993. At that time, the Congress will convene to examine the progress of the economic reforms.

Id. (citing *Congress Decree on Economic Reform*, F.B.I.S., Dec. 18, 1992, at 55). For a text of Decree No. 4047-1 of the Congress of Russian Federation People's Deputies "On the Progress of Economic Reform in the Russian Federation," see *id.* (citing ROSSIYSKAYA GAZETA, Dec. 15, 1992, at 6).

145. The first year under the new Russian tax system has been extraordinary. In December 1991, Russia adopted an entirely new tax regime, with new taxes on corporate profits, individual income, income from banking and insurance activities, inheritance and gifts, property of enterprises, and land ownership. Excise taxes, import and export taxes, and one of the world's highest value-added taxes rounded out the array of taxes devised to meet shortfalls in government revenues following liberalization of the Russian economy. Almost all of the tax statutes adopted in 1991 have been amended several times, and new regulations appear daily. Trinklein, *Year in Review*, *supra* note 135.

portion of the national heritage be shared with foreign parties or, even, with domestic rivals; and,

(6) The impact of hyper-inflation.

This is a situation where a country desperately needs a "jump start" for its oil economy but may have tremendous concern that any sharing of the wealth to accomplish this objective is national heresy.¹⁴⁶ This, in turn, contributes to initiatives to expand and perpetuate an already onerous Russian tax system. The burdensome tax system, in response, produces a withdrawal of serious, large investors from that marketplace.

Perhaps some time must evolve before the Russian side eventually realizes that it cannot "go it alone"—which, except for privately negotiated agreements, seems to be the overall message of the current Russian tax regime to potential international energy sector investors. Energy technology obtained at a reasonable price from the international oil companies today will certainly produce a preferred result when compared to a delayed response, hyperinflation, and its resultant disruptions

146. Finance Minister V.V. Barchuk discussed tax policy reform measures in the 1993 budget at the Russian Federation Supreme Soviet session on December 16, 1992. Barchuk conceded that the government needs to simultaneously "relax the tax burden somewhat and . . . strengthen anti-inflationary trends throughout the entire taxation system." He also urged strengthening the social orientation of the tax system and new tax reforms to support "entrepreneurial activity at home." Barchuk praised Russia's long-term policy of profits taxation but criticized government policies regarding value-added tax (VAT). Quoting the Economics Ministry's projection that national profits will amount to 13.5 million rubles in 1993, he assured that "a less harsh [profits tax] policy might possibly bring fruits of its own, but only in two or three years time." He noted that agriculture and numerous construction organizations will not be subject to tax on profits, and entrepreneurs will only be taxed on 25% of their activities. Profits invested in social infrastructure projects and efforts to expand or modernize are exempt from tax. Profits of monopolistic corporations, on the other hand, are subject to a new "supertax." According to Barchuk, the drastic VAT reduction from 28% to 20%, enacted January 1, 1993, "will not produce anything effective apart from a reduction in the budget revenue." He proposed reducing the rate "more gently" this year by bringing the rate back up to 23-24%. To quell increases in the wage fund, the government has introduced a new measure, whereby labor costs that exceed the normative level are no longer considered production costs and are subject to tax. *Russian Finance Minister Discussed Tax Policy Reforms in the 1993 Budget*, Tax Notes Int'l (Daily Serv.), Jan. 14, 1993, available in LEXIS, Fedtax Library, TNI File, at 93 TNI 9-3 (citing *Views 1993 Draft Budget*, F.B.I.S., Dec. 18, 1992, at 53; Moscow Russian Television Network (Dec. 16, 1992)).

(including political disequilibrium), and other similar effects. We can only hope that, as the market system slowly becomes more imbedded in smaller scale activities in Russia, the Russian tax system will respond to the market necessities like a phoenix rising from the current tax ashes!

APPENDIX ONE

SUMMARY OF ACTIVITIES OF THE PROJECT'S
TAX AND FISCAL GROUP

I. GENERAL OBSERVATIONS

The Tax and Fiscal Group Co-Reporters held extended meetings with various Russian delegation members in Houston (November 1991 and November 1992); Washington, D.C. (June 1992); and Moscow (December 1991 and May 1992). During the early stages our meetings were primarily focused on assisting the Russians in understanding the fundamentals of taxation systems in the context of a market oriented economy. During the earliest stages this included providing information about fundamental tax and economic theory, including extensively examining the concept of "internal rate of return."

We provided the Russians with extensive memoranda concerning a wide variety of petroleum tax policy issues. These were also provided to the industry representatives and to representatives of the World Bank. These are identified in greater detail in the accompanying chronological summary, but they included:

(a) An initial memorandum providing an extensive description of the U.S. system of taxation of petroleum exploration and development activities, accompanied by a summary of special petroleum taxation in many other countries.

(b) A "supertax" memorandum, with comments including (1) observations concerning the necessity for a defined fiscal regime; (2) an identification of how Russia is perceived when international investor companies make international risk assessments; (3) certain comparative information about other petroleum producing country taxing systems; and (iv) a potential structure for a "supertax."

Unlike the other advisory groups which were part of this project, we ultimately did not provide specific drafts of proposed tax legislation. This can be explained from several perspectives:

(a) The usual tax legislative process (including, for example, in the United States) first decides on the fundamentals, including the preparation of policy summaries, position papers, and revenue projections; and

(b) Petroleum tax legislation was, and remains, part of the much more comprehensive tax system of the Russian Federation. During our activities we often found a wide variety of other tax efforts outside the petroleum area (e.g., income tax legislation, the value added tax, and the Russian-U.S. income tax treaty) directly impacted on our efforts, but we were not participants in (and often were not aware of) these efforts.

II. SPECIFIC OBSERVATIONS CONCERNING THE RESULTS OF THE ACTIVITIES OF THE TAX AND FISCAL GROUP

We believe that we made immense progress in creating an environment for those Russians with whom we regularly consulted (primarily Shatalov, Klubnichkin, and Volynskaya) to understand how a tax system should function in a large, market oriented economy. However, the application of a rational taxation system to the evolving Russian petroleum industry ultimately seemed (and still seems) to be problematical.

The general impression is that, in this context, certain members on the Russian side are fixated on a "supertax", or super-profits tax, or an added-profits tax, without considering the overall impact on the entire Russian tax regime. Those individuals may be reflecting political concern about sharing any of the "national heritage" (i.e., oil) with foreign groups. Both we and the World Bank representatives regularly provided information that the overall impact of the Russian taxation system (even before considering possible political risks) is, effectively, confiscatory and, accordingly, not conducive to encouraging investment in the energy sector.

Apparently, many of the Russians partially believe that they can "go it alone" on this issue, not comprehending the applicability in this context of the concept "time is money." However, in many instances, private contractual arrangements (effectively incorporating private tax systems) have been negotiated. Not only does this approach undermine the implementation of a generally applicable tax system but, over time, invites

governmental scrutiny of those private arrangements and, perhaps their repudiation.

III. CHRONOLOGICAL SUMMARY OF TAX AND FISCAL GROUP'S ACTIVITIES

November 1991

When the Russian delegation visited Houston the Co-Reporters and the advisory group members spent considerable time with certain members explaining fundamentals of market economy tax systems. We provided an extensive memorandum which included segments summarizing: (1) general concepts of oil and gas taxation; (2) issues and options for the taxation of foreign companies in Russia; and (3) comparative tax information concerning other countries. We spent significant time with Mikhail Klubnichkin, member of the Russian Petroleum Task Force and Laboratory Director in the Scientific Pricing Center of the Institute of Pricing, and Natalya Volynskaya, member of the Russian Petroleum Task Force and Senior Scientific Associate of the All-Union Scientific Research Institute of Complex Energy Problems.

December 1991

1. Early during December 1991, William Streng and Ray Jones travelled to Moscow for a number of meetings with M. Klubnichkin and others to discuss the fundamentals of petroleum taxation.

2. After returning from Moscow, we circulated to the Working Group members several memoranda, the first providing copies of various tax (and related) legislation and the second summarizing the then enacted and proposed Russian tax laws and fiscal provisions in related legislation applicable to Russian oil and gas activities include: (1) the RSFSR Foreign Investment Law; (2) the Natural Resources Code; (3) the RSFSR Petroleum Code; (4) the Income Tax Law; (5) the Value Added Tax; (6) Cost Accounting Rules; and (7) a possible "supertax" regime.

January 1992

1. After returning from Moscow, we responded to Mr. Klubnichkin's request made in Moscow and sent information

and substantial materials to him concerning "transfer pricing" rules applicable in the taxation context.

2. Additionally, we prepared a memorandum summarizing what we understood to be the Russian tax system, particularly with respect to income taxation. We were confused concerning the then current income tax legislation and sought clarification. It appeared that no current version of Russian income tax legislation provided for a net income tax which would be creditable for U.S. income tax purposes (a matter probably solved for U.S. companies in the subsequently released Russian-U.S. income tax treaty). We also noted other tax matters in that memorandum, particularly with respect to the value added tax.

3. We noted in a memorandum to George Hardy that we could also provide some ideas concerning concepts and language to be incorporated into bilateral tax treaties or a multilateral tax treaty between the various republics in the CIS. Each republic will probably be seeking its own revenue sources from transactions crossing its borders, necessitating precise rules for the allocation of tax jurisdiction.

February-March 1992

1. The Co-Reporters developed memoranda addressed to George Hardy concerning his proposal for a self-contained taxation system for the petroleum industry in Russia. The industry representatives in the working group were opposed to an approach on this basis, noting that a large number of problems would arise from any attempt to institute such an independent petroleum tax regime.

2. The co-reporters did develop a position paper concerning questions to be examined in constructing a Russian taxation system exclusively for Russian based oil and gas activities. For purposes of this memorandum, we assumed that a decision had been made that Russian oil and gas activities should be subject to a separate taxation regime.

3. The Tax and Fiscal Group members held a substantial number of meetings during early 1992 to develop (1) a "super-tax" memorandum for submission to the Ministry of Fuel and Energy in Moscow; and (2) to further examine (but ultimately reject as a recommendation) a proposal that taxation for petroleum activities in Russia be subject to a separate, self-contained taxation system, immune from any other taxation laws of

general applicability and any other fiscal regimes, fee systems, currency conversion requirements, and similar matters.

April 1992

1. On April 10, a meeting was held at the University of Houston Law Center to report to the sponsors on the progress of the project. Extensive meetings were held with various tax group representatives.

2. The memorandum primarily addressing the issue of the possible enactment of a "supertax" to be imposed on income derived from Russian based oil and gas activities was completed and transmittal to the Russians was requested.

May 1992

1. William Streng, Ray Jones, and Richard Gordon travelled to Moscow for further discussions concerning the current status of Russian petroleum tax legislation. Material prepared and provided to the various Russian representatives (and World Bank representatives) during those meetings included:

(a) An "Executive Summary—Fundamental Issues Concerning Russian Oil and Gas Tax Legislation." This constituted the basis for our continuing discussions with both World Bank representatives and the Russian Working Group Members.

(b) A more detailed "Memorandum Identifying Fundamental Russian Oil & Gas Taxation Considerations."

(c) The "Supertax" Memorandum (as dated April 28, 1992), further revised to incorporate certain suggestions made by World Bank representatives.

During the week in Moscow other meetings were held with the following individuals:

(a) Dr. Serghei D. Shatalov, Chairman of the Sub-Commission on Tax Policy, Supreme Soviet of the RSFSR;

(b) Sergej V. Gorbachev, Deputy Minister of Finance of the Russian Federation; also attending was Vladimir Y. Volodin, Chief Specialist of the Foreign Relations Department, Ministry of Finance;

(c) Uri Alexandrovich Petrov, Director of the Economic Directorate, Export Tax, Ministry of Foreign Economic Relations; also attending this meeting were Nikolai V. Baisogolov, Deputy Chief of Economic Dept., Committee of Foreign Economic Relations, RSFSR Ministry of External Affairs, and V.G. Goljakov, Deputy Chief of the General Department, Ministry for Foreign Economic Relations.

(d) Members of the Russian Working Group.

We were accompanied at many of these meetings by World Bank representatives and World Bank consultants, including (1) Charles McPherson of the World Bank; (2) David Craig, Senior Economist, World Bank; (3) Prof. Thane Gustafson of Georgetown University; (4) Professor Peter Cameron, Rijkuniversiteit Leiden, The Netherlands; (5) Professor Alexander Kemp, Aberdeen University; and (6) Honore Le Leuch, Beicip-Franlab, Paris, France. During our time in Moscow we also had the opportunity to visit with the tax treaty negotiators from the U.S. Treasury Department and the U.S. Internal Revenue Service. They anticipated that their negotiations would produce an initialled income tax treaty draft, to be signed when Mr. Yeltsin was subsequently in Washington, D.C. (and this did then occur during June 1992).

2. After our return from the Moscow trip, memoranda were prepared and addressed to Project Director George Hardy, concerning whether draft legislation to deal with (1) special oil and gas provisions in the income tax code and (2) an additional cash-flow tax (or "supertax") would be appropriate and, if so, how such legislation might be configured.

June 1992

Prior to the Washington, D.C., meeting (noted below) copies of various Russian petroleum taxation documents which The World Bank had prepared were distributed to the Tax Group members, and various comments were received from those members.

July 1992

1. On July 2 and 3, 1992, William Streng and Ray Jones met at World Bank headquarters in Washington, D.C., with various Russian representatives. Those primarily participating

in the tax discussion included S. Shatalov (Supreme Soviet), Mikhail Klubnichkin (Interrepublic Price Committee), Natalia Volynskaya (Fuel & Energy Research Institute, Russian Ministry of Economics), and Mansour Gazeyev (Ministry of Fuel and Power). The World Bank representatives were Charles McPherson and David Craig, accompanied by the Bank's consultants Honore Le Leuch (Beicip-Franlab, Paris) and Professor Alexander Kemp (University of Aberdeen).

The objective in these meetings (particularly the focus of the World Bank representatives) was to attempt to convince the Russians that, after the current "transition period," the Russian Federation needs to have a system whereby the fiscal payments in the petroleum exploration, development, and production context would consist exclusively of three components: (1) royalty; (2) the regular business profits tax (in a creditable form); and (3) a limited additional or special petroleum fee or tax (i.e., some form of "cash flow profits tax" or "supertax"). This additional tax could probably best be incorporated into the licensing agreement; the tax amount or percentage to be determined by taking into account the anticipated variables pertinent to the particular geological prospect being licensed.

2. Subsequently, during July, 1992, the reporters provided to tax advisory group members a memorandum concerning the results of the tax meetings in Washington, D.C. at the World Bank offices.

November, 1992

1. Various meetings were held with Russian tax representatives, including in an open forum and in extensive subsequent discussions. To analyze the financial effect of the proposed "supertax" the group reviewed a chart (prepared by Greg Vojack (UH)) entitled "Hypothetical Ton of Crude Exported from Russia." This table sets forth the various taxes and other payments to government applicable to such production under the laws currently understood to be in effect.

2. The Russian representatives provided various tax proposals for that meeting. Additionally, Professor Streng developed materials for background discussion at those meetings, including an executive summary of the fundamental issues concerning Russian oil and gas tax legislation and a summary of the important provisions of the Russia-U.S. income tax treaty.

3. Dr. Shatalov requested the audience comments concerning Russian taxation which were received at the November 10, 1992 general meeting in Houston. Those comments were prepared in summarized form and delivery to him was requested.

4. At a subsequent meeting during the November 1992 visit at the University of Houston Law Center, Dr. Shatalov requested information concerning how to deal with inflation in implementing taxation rules (particularly in the depreciation context). Prior to his departure from Houston, some materials concerning this issue were furnished to him (i.e., excerpts from a study released by the U.S. Treasury Department in 1984 concerning proposed inflation indexation for depreciable assets, other capital assets, inventories, and indebtedness). Extensive further information concerning this matter was forwarded to Dr. Shatalov during November, 1992.

5. Professor Streng provided to various parties a November 2, 1992 letter sent by the Deputy Secretary of the Treasury with respect to the creditability of the Russian income tax (probably the most important tax issue to U.S. oil and gas companies) that infers that; even though the U.S. Treasury Department negotiated the recent Russia-U.S. income tax treaty to assure eligibility for the foreign tax credit (for U.S. income tax purposes), the Internal Revenue Service may not necessarily recognize that status.

6. A short time after the November meetings with the Russian delegation, a detailed summary of the smaller group discussion (as prepared by Roger Bonney) was circulated to the U.S. working group members. The Tax and Fiscal Group wants to particularly thank Roger Bonney for his efforts in developing this particularly useful summary.

December 1992

During December 1992, Professor Streng forwarded to Dr. Shatalov a copy of a recently released "Basic World Tax Code" prepared under a project sponsored by the Harvard University International Tax Program. This was prepared for the use of tax policy makers and administrators in countries with developing economies or "in transition to a market economy." This material could be useful in enabling him and his advisors to examine the comprehensive structuring of the evolving Russian taxation system. The accompanying commentary provides a basic explanation of the proposed code provisions. This was sent

only in the English language, but with a request to Charles McPherson at the World Bank to arrange for a translation of this material into the Russian language, thereby facilitating its greater usefulness to Dr. Shatalov and his colleagues.

Anticipated in Early 1993

The industry representatives continue to develop a list of technical tax questions which we anticipate presenting to Dr. Shatalov. One objective of this process is to assure that the Russians have focused on a large number of technical but very important questions. Dr. Shatalov indicated that, to the extent he can not provide answers, he would request a response from the Ministry of Finance.

APPENDIX TWO

CASH FLOW CHART

SUMMARY OF EXISTING GOVERNMENT TAKE¹⁴⁷
(AMOUNTS IN U.S. DOLLARS)

Sales Price per Ton for Russian Export Blend	125.00
Export Tariff (at 30.0 ECUs per ton)	36.00 ¹⁴⁸
Royalty (Mineral Use Rights)	
8% of revenue	10.00 ¹⁴⁹
Payment for replacement of mineral raw materials	
10% of revenue	12.50 ¹⁵⁰

147. Note that this summary is premised on the anticipated experience of a U.S. based company. It assumes a prevailing per barrel crude oil world price in U.S. dollars. Similar results for other Western companies could be anticipated. Please note that not all assumptions may be applicable in every situation, for example, the 40% currency conversion factor. For a somewhat similar analysis, see WALLICH, *supra* note 11, at 106 (providing a chart showing that for oil production sold in the Russian domestic market the aggregate tax (and "quasi-tax") rate is 91.8% before any expenses (which include income tax) and the aggregate tax for similar production sold in the export market is 52.5%, again before expenses (which include applicable income tax)).

148. The export tariff for crude oil is currently reported to be 30 ECUs per ton of crude oil. On November 26, 1992, the news agency Interfax reported that the Russian government was considering eliminating or reducing this tax, but apparently this has not occurred.

149. The payment for the right to use subsurface resources was described in the Subsurface Resources Law published during 1992. Decree 478 of the Government of the Russian Federation, dated July 9, 1992, established temporary minimum rates of payments for the right to use subsurface resources from June 1, 1992. The rate for crude oil was established at 8% of the value produced. Additionally, this decree permits possible modification of this rate up to 30% depending on the natural, geographical, mining, economic, and other conditions of the deposits. However, under a probable worst case situation, this royalty would probably be at a rate of 10.4% of the world market price.

150. The payment for the replacement of mineral raw materials was calculated on the basis of 10% of the export value of the crude oil. Similar to the payment for the right to use subsurface resources, some question exists whether the basis for the calculation (the "value") should be the regulated wholesale price or the export price. Some Russian representatives have suggested that this payment requirement was not intended to apply to foreign investors, but the ap-

Transportation cost	\$13.00 per ton	13.00 ¹⁵¹
Road Use Tax		.50 ¹⁵²
Excise tax		2.16 ¹⁵³
Gravity Adjustment		0
Pipeline losses		3.75 ¹⁵⁴
Mandatory currency conversion		.56 ¹⁵⁵
Other costs		? ¹⁵⁶
Total direct taxes and costs		<hr/> 78.47
Net proceeds from export		<hr/> 46.53
Hypothetical lease operating costs		7.00
Hypothetical administrative and general expenses		20.00
Taxable income		<hr/> 19.53

licable legislation does not specify any such exception.

151. This constitutes the approximate total transportation cost for a ton of crude from Western Siberia. This amount consists of (1) local tariff, (2) Transneft, (3) Siberian pipeline, and (4) SNE. This estimate may be too low if crude oil is transported through other republics.

152. The Motor Road Use Tax is payable by all enterprises at a rate of 0.4% of revenues. RSFSR Law No. 1759-1, On the Road Funds in the RSFSR, Oct. 18, 1991, (on file with author). Apparently, this tax is significantly greater on those enterprises which sell fuel and lubricants to the final consumer.

153. The excise tax is assumed to be imposed at the rate of 18%. Decree No. 847, dated November 1, 1992, as signed by Yegor Gaidar, introduced the minerals excise tax. This Decree established excise tax rates ranging from 5% to 30% for various production associations based on the ease of mineral extraction. Production associations which are not listed in this Decree are subject to an 18% tax. The most logical assumption appears to be that this tax will generally be imposed at the rate of 18% of the wholesale, regulated price.

154. Presumed to be 3% of production.

155. This cost is assumed to be one percent of the amount converted. Apparently, many foreign enterprises subject to the mandatory conversion requirements are purchasing the equivalent amount of U.S. dollars on the same day that they are selling 50% of their hard currency earnings under the mandatory sale requirement. The net effect is that the foreign enterprise will pay approximately a one percent service charge for this exchange transaction. This cost might be reduced if rubles are retained for use in domestic (i.e., Russian) operations, but the currency exchange risk must then be considered.

156. Other costs cannot be quantified. No amounts are included in this summary for annual property taxes, anticipated to approximate one percent of value.

Less: "Double deduction" for capital expenditures	9.77 ¹⁵⁷
Adjusted taxable income	<u>9.77</u>
Profits tax (at 32%)	<u>3.13</u>
Net income	<u>16.41¹⁵⁸</u>
Super-profits tax (if any)	<u>?¹⁵⁹</u>
Net income after super-profits tax	?
U.S. net income tax liability (at 35% ¹⁶⁰ before foreign tax credit)	?
Available foreign tax credit (U.S. taxpayer)	?
Net to U.S. taxpayer after foreign tax credit	<u>?</u>

157. Article 7.1a of The Law on Taxation of Profits allows enterprises participating in the oil and gas industry to reduce their taxable base by the amount of profit allocated to modernization, reconstruction, expansion, and development of production. This reduction cannot exceed the taxable base by more than 50%. Most foreign owned oil and gas joint ventures have budgeted capital expenditures in excess of projected profits during the initial phase of operations in Russia and, accordingly, will be subject to this 50% limitation.

158. This projection does not consider that profits might be immediately distributions as dividends and, if this occurs, a further dividend withholding at source would be applicable. Under the Russia-U.S. Income Tax Treaty that withholding would be imposed at the rate of 5% (in the case of a U.S. corporation owning at least 10% of the voting shares of, if there are none, of the capital interest) in the distributing Russian entity. With the Russian profits tax imposed at a 32% rate the 5% withholding tax will raise the nominal combined tax burden to 35.4%.

159. One group of Russian representatives indicated that a "supertax" would apply at rates varying from 50% to 86% and that this tax would apply at different tiers, depending on the present value net cash flow. Consequently, the extent that the present value net cash flow, discounted at 15% would exceed zero the first tier supertax would be levied at the rate of 50% of the excess. If present value net cash flow after the first tier supertax discounted at 30% exceeds zero the second tier supertax would be levied at the rate of 85% on such excess.

160. This assumes enactment of tax legislation during 1993 increasing the federal corporate tax rate to 35%.

APPENDIX THREE

SUMMARY OF COUNTRY RISK EVALUATION PROCESS

Representatives of the Tax Group of the University of Houston Russian Petroleum Legislation Drafting Project provided information concerning "country risk" in an effort to demonstrate to the Russians that international energy companies will insist upon greater return (and lesser taxation) than could be anticipated in a highly developed country. The representation was that, under present conditions, Russia is a high risk jurisdiction and, therefore, could not consider itself to be in the same category as, for example, the United Kingdom (which imposes the Petroleum Revenue Tax), when imposing taxation which significantly impacts on the cash flow return from the project for the international energy company.

Those country risk classification charts are not included here. However, the methodology in classifying countries on the basis of country risk is included here.

Country risk evaluation information is available from by several sources, including:

- (1) The International Country Risk Guide, a world-wide ranking of countries, rank-ordered according to relative investment risk. This listing is compiled by Eurostudy, an independent international risk monitoring agency based in London.
- (2) Frost & Sullivan's Political Risk Services, based in New York.
- (3) Business International, Geneva, Switzerland.
- (4) Multi-National Strategy, New York.

Other groups provide similar information. The Export-Import Bank of the United States, and similar U.S. government agencies have also developed similar ranking information, but that information is ordinarily not publicly available.

The information which was provided to the Russian delegation from some of these sources indicated that Russia was then classified as a high risk country. Such rankings are made on various bases: (1) political risk (e.g., turmoil potential); (2) financial risk (e.g., currency transfer risk); (3) economic risk

(e.g., business success potential); (4) composite rankings. Rankings are sometimes made on the basis of short-term and longer term (e.g., five year) time horizons.

The elements included with "political risks" might include economic planning failures of the local government, the stability of the political leadership, possible conflicts and uprisings, governmental corruption, military interference in governmental processes, racial and nationality tensions, civil war risks, and the quality of the government bureaucracy. Elements considered in determining "financial risks" might include loan defaults in the foreign country, delayed payments due to lack of foreign exchange, the repudiation of contracts by the local government, and the incidence of expropriation of private investment. The "economic risk" determination may be based on factors such as inflation, debt service as a percentage of exports, the international liquidity of the country, the foreign exchange position, and the current account deficit as a percentage of the country's exports.

Other factors which can impact various of these evaluation factors might include restrictions on local operations, such as on labor, management and procurement, taxation discrimination, labor costs, nontariff barriers, and restrictions on equity ownership in the local country.

APPENDIX FOUR

SUMMARY OF OIL & GAS TAXATION IN
CERTAIN OTHER COUNTRIES

(as of January 1992)

The Russian side indicated (as noted in the text) a possible interest in a "return based tax" or production sharing system.¹⁶¹ For purposes of enabling the Russian government representatives to make comparisons, summaries of information concerning the taxing regimes in various oil producing countries were developed. We did note, however, that circumstances in Russia are quite different from those in many of these countries. We indicated to the Russian government representatives that many of these particular fiscal regimes are far more complex than are really necessary for Russian purposes.

The countries examined for comparative purposes were Australia, China, Germany, Indonesia, Malaysia, Netherlands, Norway, Tunisia, and the United Kingdom. These countries, we noted, are located in various geographical sectors of the world and have very different political systems and governmental stability.¹⁶²

We omitted any discussion of VAT in our summaries because the input credit allowed for all business purchases of goods and services (including fixed assets) eliminates any economic impact on petroleum operations in those countries imposing such a tax. We did note, however, that imposition of the twenty percent VAT on total fixed asset costs, with no input credit, would likely quite negatively impact the economic viability

161. See McPherson & Palmer, *supra* note 123, at 119. No subsequent information has apparently been published to update the material provided in that article.

162. In its report, the World Bank has provided a similar comparative analysis entitled "Natural Resource Taxation: International Practice in Federations." WALLICH, *supra* note 11, at 109 (noting that "industrialized nations with federal systems of government have ineffectively assigned taxes on natural resources" and describing the taxation systems in the United States, Canada, Australia, Nigeria, Malaysia, Papua New Guinea, and Brazil).

ty of any petroleum exploration and production project in the RSFSR.

Australia

A corporate income tax is imposed at a thirty-nine percent rate. A remittance tax is imposed on dividends which are in excess of tax paid earnings (subject to a fifteen percent withholding tax if distributed to shareholders in a treaty country and to a thirty percent withholding tax if distributed to shareholders in a non-treaty country).

More importantly, for purposes of this discussion, a Petroleum Resource Rent Tax (RRT) is imposed at a forty percent rate, applicable to income derived from offshore petroleum projects. This rate-of-return tax is applicable to income derived from offshore petroleum projects. The tax base for each project is the excess of accrued project-related receipts over (1) project expenditures for the years; (2) undeducted exploration and other expenditures incurred more than five years prior to the taxpayer's first production license compounded forward at a rate equal to Australia's GDP deflator; (3) other undeducted exploration expenditures compounded forward at a rate equal to Australia's long term bond rate, plus fifteen percentage points; (4) undeducted project development and production costs compounded forward at a rate equal to the long term bond rate plus five percentage points; and (5) environmental restoration and other costs of closing down the project. Capital expenditures as well as expenditures of an ordinary nature are fully deductible in the year incurred.

Petroleum activities are generally "ring-fenced" on a project-by-project basis, subject to an exception allowing exploration costs to be deducted against the resource rent tax income derived from any project. A petroleum project generally consists of a production license area plus treatment and related facilities outside the area which are necessary to the production of marketable petroleum commodities (i.e., stabilized crude, condensate, LPG, etc.). With government approval two or more projects may be treated as a single project.

The resource rent tax liability is deductible for corporate income tax purposes.

China

A production sharing contract is the type of contract entered into with the Chinese. Cost Oil is limited to a negotiated percentage of production, with excess costs then being carried forward. Profit Oil which remains after deducting Commercial and Industrial Consolidated Tax (CICT), royalty, and Cost oil is split into the Chinese share oil and the Allocable Remainder Oil. The amount of Allocable Remainder Oil is determined based upon negotiated "X-factors" applicable to differing levels of production.

The government take consists of bonus, CICT, royalty, direct participation, income tax and withholding tax. Typically, a negotiated small signature bonus is paid. The CICT is five percent of crude oil revenue, payable in kind. The royalty is payable on a sliding scale. The income tax applicable to a joint venture is thirty percent, plus a local surtax of ten percent, resulting in an effective tax rate of thirty-three percent. The income tax is applied on a consolidated company basis.

Germany

Germany has no special petroleum tax regime. Rather the taxes and government take consists of various taxes applicable to a German corporation conducting extraction activities in Germany. The applicable taxes and government take consist of (1) net worth tax, (2) trade capital tax, (3) trade income tax, (4) corporate income tax, (5) withholding tax, (6) royalties, and (7) value added tax.

The trade taxable income of a corporation is subject to tax at approximately a seventeen percent rate. The rate may vary within regions in Germany. The trade taxable income tax is a creditable tax for U.S. income tax purposes.

The corporate income tax is imposed on an integrated tax system basis. A fifty percent tax rate applies to undistributed corporate taxable income. When a dividend is paid, the corporate payor in essence gets a rebate of tax reducing the corporate income tax to thirty-six percent. A special surcharge may also be applicable. Exploration costs are generally currently deductible but certain "deep drilling" costs must be capitalized and amortized over periods ranging from eight to fifteen years.

If such "deep drilling" costs are unsuccessful, they may be written off at that time.

Concession acquisition costs are amortized on a straight line basis over the life of the concession. Acquisition costs are similar to bonus payments in the United States that are made to a landowner. Purchased seismic data is amortizable on a straight line basis over the life of the concession. Royalties are currently deductible. No authority exists to enable the establishment of a reserve for abandonment expenses. This corporate income tax is a creditable income tax for purposes of determining U.S. income tax liability.

The general withholding tax on dividends paid by a German corporation to a foreign corporate owner is twenty-five percent. This rate can be reduced under applicable treaties. Under the German-U.S. income tax treaty the rate is five percent.

Note that Germany also has a value added tax which may generate significant additional cost.

Indonesia

Indonesia also has profit sharing as the mechanism for dividing oil production proceeds between industry and the government. Cost Oil is limited to eighty percent of production, with excess costs carried forward. Profit Oil is generally split 71.2% for Pertamina (the government oil company) and 28.8% for the contractor. A capital uplift of seventeen percent of capital costs is available.

The government take consists of bonus, direct participation, income tax, withholding tax, and a domestic supply obligation. The bonuses are biddable signature bonuses and production bonuses and are tax deductible. The income tax is a general corporate tax rate of thirty-five percent. The withholding tax is a twenty percent dividend withholding tax. This results in a combined Indonesian effective income tax rate of forty-eight percent.

Under a domestic supply obligation, the contractor may be required to sell up to twenty-five percent of its allocated share of production to the Indonesian domestic market. For the first five years of the contract, the world market price is payable but, thereafter, the price is only ten percent of the world market value. The government has the right to nominate the Indonesian company to participate in this arrangement.

Malaysia

Malaysia also has profit sharing as the mechanism for dividing oil production proceeds between industry and the government. Cost Oil is limited to fifty percent of production, with excess costs carried forward. Profit Oil, from a specified contract area remaining after deducting the Cost Oil, is split between Petronas (the government oil company) and the Contractor. The share to Petronas increases as production increases and the share to the contractor decreases (reaching the lowest level of thirty percent) as production increases.

The government take consists of royalty, direct participation, income tax, export tax, and excess profits tax. The royalty is ten percent of gross production. The income tax is the general Malaysian corporate income tax rate of thirty-five percent and a three percent development tax is also imposed. However, income from a production sharing contract is taxed at a forty-five percent rate. The export tax is twenty-five percent on Profit Oil. The export tax is deductible for Malaysian income tax purposes. The excess profit tax is seventy percent, applied when crude oil revenues exceeds U.S. \$25 per barrel, with the price escalated at five percent per year beginning in 1988. No withholding tax is applicable.

Netherlands

The Netherlands oil and gas fiscal regime includes royalty, corporate income tax, the state profit share, and a right to state participation in development on a retroactive basis. The royalty, the state profit share, and the participation rights vary according to the terms under which the license is granted.

The overall fiscal regime is integrated in that royalties are deductible for both corporate income tax and state profit share purposes. The corporate income tax and the state profit share are both further integrated by the state profit share being deductible for corporate income tax purposes and the corporate income tax being creditable against the state profit share. The simultaneous equation required to determine the overall liability is complex but insures that the government will receive no less than the corporate income tax liability and that the taxpayer will pay not more than the state profit share liability.

The corporate income tax is creditable for U.S. income tax purposes, but the state profit share is not creditable for this purpose.

Norway

The principal forms of taxation and "government take" for an enterprise involved in extraction activities in Norway are state tax, municipal tax, special petroleum tax, capital tax, royalty, value added tax, and withholding tax.

The State Tax, a net income tax, is imposed at the rate of 27.8%. A deduction is allowed in the State Tax income tax base for dividends paid. A statutory formula is followed requiring certain allocation to a "Reserve Fund" in calculating the amount of dividend that can be paid. Neither the Municipal Tax nor the Special Petroleum Tax is deductible in computing the State Tax taxable income base. The State Tax is a creditable income tax for U.S. income tax purposes.

The Municipal Tax Rate is twenty-three percent. Royalties are deductible in computing the taxable income for Municipal tax (and, also, the Special Petroleum Tax and the State Tax). Depreciation on production expenditures commences when the investment is made and is written off on a straight line basis over six years. Exploration costs can be capitalized in whole or in part or deducted currently. Interest expense can be capitalized or expenses at the taxpayer's option. If capitalized, it becomes part of the asset's depreciable base. The Municipal Tax is also a creditable tax for purposes of the U.S. income tax.

The Special Petroleum Tax is applicable to oil and gas extraction operations on the Norwegian continental shelf. Losses from activities that are considered "onshore activities" cannot be deducted against Special Petroleum Tax taxable income. The Special Petroleum Tax rate is thirty percent. A special production allowance equal to fifteen percent of the value of the petroleum produced, calculated at a "Norm Price," is deductible in arriving at Special Petroleum Tax taxable income. Neither the State Tax nor the Municipal Tax is deductible in computing the Special Petroleum Tax taxable income. The creditability of the Special Petroleum Tax is not clear. This tax is creditable under the Norwegian-U.S. income tax treaty, subject to certain limitations.

A capital tax equal to 0.3% of the net worth of a corporation is assessed annually. The Capital Tax is not a creditable tax for purposes of the U.S. income tax.

Tunisia

Operations in Tunisia are subject to taxation based on terms and conditions in the individual permit "Conventions." Each convention allows the taxpayer to be taxed under the Convention or elect to be taxed under special fiscal terms of "Marginal Field Legislation." This taxation election is normally made when a plan of development for a concession is submitted to the governmental authority. Taxation under this system is based on a net income calculation, with allowances for appropriate expenditures, including depreciation at ten percent to thirty percent per year. A three-year carryforward of losses is ordinarily allowed.

Under the Convention tax system, a fixed royalty rate of fifteen percent is imposed, coupled with a variable tax rate.

United Kingdom

Production royalties are payable to the government. For offshore licenses the royalty rate has often been 12.5% of the specified value.

Of most importance in the Petroleum Revenue Tax (PRT), a production based tax levied on profits from oil and gas extraction activities in the United States or in designated areas of the U.K. continental shelf. Each oil field is essentially treated as a separate taxpaying entity, regardless of the number of fields in which a company may have interests. The PRT profit or loss has no direct relationship to accounting profit, generally being the difference between income and the expenditure determined under specified rules. The rate of the PRT has been seventy-five percent, but the "effective rate" on commercial profits is often less because of the incidence of "uplift," "oil allowance," and other moderating factors. The uplift is a supplement added to certain qualifying expenditures prior to payback, intended to compensate for return on various investments. During 1993, this tax has been substantially revised.

APPENDIX FIVE

I. STRUCTURE OF A POSSIBLE CASH FLOW TAX

If in spite of the above comments or if the remaining tax regime is moderated and a supertax is ultimately deemed warranted within the Russian Republic, this tax could be a (non-confiscatory) rate of return (ROR) type tax based on the oil company's hard currency cash flows. This type of supertax should enable complete cost recovery, plus some reasonable return on investment, prior to the time that the supertax would become applicable. This structure would partially ameliorate the investment disincentive implicit in the supertax by allowing international energy companies an acceptable rate of return and the opportunity to participate in upside returns, albeit at a reduced level.

The threshold rate of return should approximate the minimum risk-adjusted rate of return required by the investor. Further, the rate of return tax would be most effective if it were applied after only a modest royalty and a general creditable corporate income tax. Consequently, a rate of return tax must be integrated with all other tax and related governmental payments. It is important to bear in mind that the relevant risk-adjusted rate of return required by the investor is project dependent, and may vary significantly, as in the instance of hydrocarbon risk in a petroleum development project versus a wildcat exploration project.

The major focus of a supertax regime should be to capture a significant segment of unanticipated market gains. This would be consistent with world practice. Certainly, a back-up system to capture such gains is important. However, presently, no apparent prospect exists for such "windfalls."

If a supertax regime is to be enacted, this tax should be administered by a central tax administration. Other countries (for example, the United Kingdom) have a central petroleum taxation bureau for the administration of special petroleum tax matters. This enables uniformity of administration and consistent treatment. An alternative mechanism to impose a supertax system would be through the concession or license arrangement itself. In this situation, alternative administrative procedures

would be required. However, each concession would presumably be different as a result of individualized negotiations, making the monitoring process more difficult.

II. Possible Structure of Supertax System

A. *Basic Structuring Considerations*

The basic framework of any super-tax or excess profits tax system should include the following features:¹⁶³

1. Super-tax Computed on Net Cash Flow

Any super-tax should not be imposed until all expenditures attributable to the investment (both those normally capitalized and those currently deductible) are recouped from the cash proceeds received from the sale of oil and gas production. For example, the tax should be computed on net cash flow which is equal to gross oil and gas sales, less royalties and all other expenditures necessary to develop and produce oil and gas in commercial quantities (including overhead, fees, taxes, etc.). If the regular income tax liability is creditable against the super-tax (as suggested below), then the regular income tax paid should be eliminated as an expenditure in determining the net cash flow.

2. Rate of Return (ROR)

Before any super-tax is imposed, the international energy companies should be entitled to recover their investment plus a predetermined ROR. The specific ROR should be determined after due consideration is given to the balancing of government and international companies' objectives, the anticipated tax rate of the super-tax regime, and the projected overall government take.

3. Limitations on Recovery of Investment

Considering the various elements of investment risk, the super-tax should be imposed on investment earnings on a country-wide basis (rather than applying a "ring-fence" concept). Limiting the international energy company's recovery of invest-

163. This summary was originally developed by Ray Jones and other representatives of Arthur Andersen & Co., Houston, Texas.

ment capital to that invested in oil and gas related activities could be appropriate

4. Inflation Protection Adjustment

The super-tax should be structured to eliminate any tax attributable solely to artificial gains created by inflation.

5. Rate of Tax

The tax rate for the super-tax regime should be set after due consideration to all components of the overall government take. The super-tax, when combined with other taxes, royalties, fees, etc., comprising government take, should result in a balance between objectives of the government and the investment objectives of the international energy companies.

6. Interaction between Super-tax and Income Tax

Any super-tax should be structured to establish parameters that essentially define the minimum and maximum amount of tax that could be imposed through a combination of the income tax and super-tax regimes. For example, the cumulative income tax paid by the international energy companies on their exploration and production activities should be creditable against the super-tax. In addition, the super-tax paid should be a deduction for regular income tax purposes.

B. Summary

The above elements of a super-tax represent only the most basic framework of a tax regime. Each element requires much refinement to meet specific circumstances and objectives. By way of example, other issues to consider might include use of a two-tiered ROR system, carryback/carryover provisions relating to crediting the income tax against the super-tax, defining oil and gas related activities, use of an uplift on expenditures and many more. In addition, extensive economic modeling is essential to determine the appropriate ROR and tax rate for the super-tax regime to insure it is appropriately integrated with the overall government take.

