TWO VIEWS of KAZAKSTAN'S SUBSOIL LAW

(Editor's Note: The article by Marla Valdez of Welborn Sullivan can be found on p. 6.)

The New Kazak Law "On the Subsoil and Its Use"

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Translated by Al Celmer, Esq.

On January 27, 1996, **Nursultan Nazarbaev** signed a decree having the force of law, "On the Subsoil and Its Use" (hereinafter the Decree). This decree entered into force from the moment of its official publication, that is, January 29, 1996. From that time, the former basic law of the Republic of Kazakstan (RK), "On the Subsoil and the Processing of Mineral Raw Materials," of May 30, 1992 and several other acts directly referred to in Article 76(1) of the new Decree were superseded.

The Legal Regulation of Subsoil Use And Its Relationship to the New Decree

The System of New Laws in the Sphere of Subsoil Use

The Decree "On the Subsoil and Its Use," was the culmination of a series of new laws of the RK adopted in 1995 and devoted to questions of subsoil use, among which the most important were the decrees of the President of the RK, having the force of law, "On Oil," of July 28, 1995 and "On the State Regulation of Relations Connected With Precious Metals and Precious Stones" of July 20, 1995.

Besides them, the presidential decree having the force of law, "On Licensing," was issued on April 17, 1995. An addendum to this, adopted on December 23, 1995, established that the peculiarities of licensing activities concerning the utilization of natural resources shall be determined by special legislation.

The legal basis in Kazakstan today includes, together with these most important decrees, a raft of other legislative acts devoted to this or that question of subsoil use. The Decree establishes that normative legal acts adopted before it went into effect may be applied as to the parts that do not conflict with the Decree (Article 74).

At the same time, it was established that the peculiarities connected with the conduct of subsoil use operations as applied to individual types of minerals and technogenic mineral formations shall be determined by special legislative acts (Article 4(1)).

Perspectives on the Further Development of Legislation on Subsoil Use

The government of the RK has been tasked with bringing legislation into conformity with the Decree before July 1, 1996, and also with elaborating and confirming a host of new normative acts on various questions of subsoil use by the same date. The latter include:

- procedures on concluding contracts for conducting subsoil use operations;
- procedures for licensing subsoil use;
- provisions on a state cadastre of the subsoil;
- provisions on geological information; and
- a model contract for conducting operations using the subsoil.

General Characteristics of the Decree

The Decree consists of 10 chapters, comprising 77 articles.

In accordance with the constitution of the RK, the subsoil and other natural resources are state property. The Decree confirms this fact.

However, during extraction of mineral raw materials (the portion of the subsoil containing useful minerals) on the surface or during extraction of useful minerals from technogenic mineral formations, the subsoil user acquires a right of ownership in the useful minerals (with the exception of Kazak state enterprises), if not otherwise established by contract, and, accordingly, a right to conclude any civil or legal transactions in relationship to them not prohibited by law (Article 5).

For the first time, it is established that all interested parties have the right to familiarize themselves at the licensing agency with licenses and contracts, with the exception of provisions recognized by the parties as confidential (Article 6).

The Decree established the ability and conditions for transferring the rights of subsoil use to another person (Articles 14(6) and 37). The agreement of the licensing agency is required for this, with the exception of transfers of subsoil rights to a subsidiary (*dochernaya organizatsiya*). For the first time the very important ability to pledge rights to subsoil use is provided (Article 15).

A progressive innovation in licensing practice in comparison with earlier legislation, is that, in cases of commercial discovery, the holder of a license to prospect has an exclusive right to receive a license to extract if he has fulfilled the requirements provided in the license to prospect (Article 34(3)). Earlier, the holder of a license to prospect had a

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priority right to obtain a license to extract, but not an *exclusive* one.

The Decree is more detailed than earlier legislation and regulates questions of conservation of the subsoil and of the surrounding natural environment.

The subsoil user is guaranteed protection of his rights with regard to legislation. Changes and additions to legislation that worsen the position of the subsoil user will not be applied to licenses and contracts issued and concluded earlier (Article 71).

The Licensing of Prospecting and Extraction

The legal relations regarding the licensing of prospecting for and extracting mineral resources are regulated in great detail in the Decree (Articles 21-41).

Earlier legislation on questions of licensing subsoil use were less detailed and clear and at the same time contained serious inconsistencies that caused difficulties in application.

Granting a License

Article 22 regulates the granting of a license, and, in particular, contains the following provisions:

- No one has the right to prospect or mine without the appropriate license, except for those cases established in the Decree (including the state's geological studies of the subsoil and extraction of widely distributed minerals and underground waters for its own needs (Article 13(3,4)).
- A contract must correspond to the conditions of the license. Provisions of a contract that are inconsistent with the license are invalid (Article 22(2)).
- A license is the unconditional basis for assignment of a plot of land, if this is necessary for conducting operations with the subsoil (Article 22(4)).

The Licensing Agency

The Republic of Kazakstan issues licenses in the person of its agencies (most often the Ministry of Geology and the Ministry of Oil and Gas), and only the issuance of a license for the extraction of widely distributed mineral resources for commercial purposes is done by the oblast authorities (Article 23).

Types of Licenses

Article 24 of the Decree divides licenses into the following types:

- a license to prospect;
- a license to extract;
- a license for the construction or exploitation of underground structures not connected to mining; and
- a combined license: a license to prospect and extract.

The text of the Decree also distinguishes another type of license — a supplementary license, which is issued without conducting a competition if, during prospecting or mining, it is discovered that the geographical boundaries of the deposit exceed the parameters of the contractual territory indicated in the license (Article 35(1)).

Methods of Obtaining a License

The Decree states that the basic method for obtaining a license is through an investment program competition [*konkurs investitsionnikh programm*], which may be open or closed (Article 25(1)). At the same time, the granting of a license on the basis of direct negotiations is permitted (Article 21). The practice up until this time in Kazakstan has been to issue licenses through direct negotiations in the majority of cases.

The Decree rather closely regulates the conditions for conducting investment program competitions and the conditions for conducting negotiations for the right to obtain a license to prospect or to mine.

Contents of the License

The Code determines the contents of a license (Articles 32, 33). In this regard, a license to prospect has several objective differences from the content of a license to extract and a combined license (thus, in the license to prospect the conditions and procedure for returning the contractual territory must be indicated).

At the same time, the reasons for several differences in the contents of these licenses are not clear. For example, both the license to prospect and the license to extract must set forth the obligations of the subsoil user to fulfill legislation on conserving the subsoil and the surrounding natural environment and for safe management of work. In this regard, Article 32 contains an indication that this must be legislation of the Republic of Kazakstan, but Article 33 does not.

From the text of Articles 32 and 33, it follows that the list of conditions determining the contents of the license is exhaustive, since the Decree has no indication that any conditions may be included in the license through agreement of the parties.

The exclusion of the ability to establish conditions in the license by agreement of the parties may hardly be considered a positive innovation of the Decree.

Periods of Validity for Licenses

The Code regulates the periods of validity of licenses in detail. A license to prospect is issued for a period of up to six years with two possible extensions of up to two years a piece (Article 34(1)). [Previously, a license to conduct geological research was issued for a period of up to five years with one or two extensions.]

A license to extract is issued for a period of up to 25 years. [Previously, the period was 20 years.] The Decree does not contain restrictions on the number and length of extensions of the license to extract. This period may be extended if the licensee applies for the extension not later than 12 months before the expiration of the license (Article 34(6)).

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A combined license is issued for a period including periods of prospecting and extraction, taking into account the possible times of extension.

Some Licensing Questions

The Decree establishes the basis for:

- suspending a license (Article 38);
- terminating a license (Article 39);
- recalling a license (Article 40); and
- declaring a license invalid (Article 41).

These actions may be applied by the licensing agency, as a rule, for some culpable conduct by the possessor of the license, as indicated in the Decree, (with the exception of cases when the license is terminated upon expiration of the time period indicated in the license or when the legal entity is liquidated (Article 39 (1,4)).

It is important to point out that Points 2-4 of Article 39 permit a license to retain its legal effect through a change of the subsoil user, which previously was categorically forbidden. Corresponding revisions were made on Dec. 23, 1995 in the decree of April 17, 1995, "On Licensing."

Contracts for Prospecting and Extraction

The Decree has five articles devoted to contracts.

The previous legislation was more laconic with regard to the extent of legal regulation of contracts concluded on the basis of licenses (with the exception of the decree "On Oil"). However, the Decree does not contain several, in our opinion, logically necessary provisions with regard to contracts.

Types of Contracts

The following types of contracts for conducting prospecting and extraction operations are set forth in Article 42:

1) production-sharing;
2) concession;
3) provision of services (service contract);
4) joint activities (with or without the formation of a legal entity); and
5) other types of contracts.

Additionally, the Decree permits combined and other types of contracts depending on the conditions of individual subsoil use operations and other circumstances (Article 42(2)).

Parties to the Contract

The Decree does not directly determine the parties (subjects) concluding the contract.

From a general analysis of the Decree, it follows that the contracting parties may be the licensee and the competent executive agency to which has been delegated the rights directly connected with concluding and fulfilling contracts.

Period of Validity of the Contract

The period of validity and conditions of a contract are determined by agreement of the parties in accordance with the applicable law and license, taking into account the provisions of the model contract (Article 43(1)). In regard to this, contractual provisions that contradict the terms of the license are invalid.

The Decree does not contain the terms and characteristics of the model contract. Currently active in the Republic of Kazakstan is the Resolution of the Cabinet of Ministers of June 27, 1995, "On the Confirmation of a Model Contract for the Exploitation of Deposits of Useful Minerals Between a Competent Agency of the Government of the Republic of Kazakstan and a Mining (Oil and Gas) Enterprise."

Based on an analysis of the aforementioned Resolution, one may say that the terms of the model contract are not obligatory for the parties and serve only as an orientation.

Concluding and Fulfilling a Contract

The status of a competent agency for concluding and fulfilling a contract is set forth in a rather general manner. The Decree contains a norm whereby the procedure for concluding contracts is determined by the government of the RK.

At the same time, the Decree sets forth several important provisions in this area, among which are the following. Before its signing in the obligatory manner, a contract is submitted for approval to the special executive agencies administering questions of protection of the surrounding natural environment, health and sanitation, protection of the subsoil, and supervision of mining. Also prior to its signing, a contract is subject to ecological and legal examination. A contract is registered in the agency authorized by the government of the RK and enters into force from the date of its registration, if a later date is not set by the contract (Article 44(1,2,3)).

Amendment and Termination of a Contract and Declaring It Invalid

A contract may be declared invalid if it was concluded without first receiving a license, if one of the parties is not a competent agency, and for other reasons provided for in legislative acts (Article 45).

A contract may be modified upon written agreement of both parties if the modifications are not inconsistent with the license (Article 46(1)).

The parties may terminate the contract only on the grounds and under the procedure provided for in legislative acts or in the contract. The Decree names recall of the license as a ground for terminating a contract (Article 46(2)).

The Legal Position of Foreign Investors

The Decree establishes as a legal principle the creation of favorable conditions for the attraction of investment and the conducting of operations in subsoil use (Article 3(7)).

The Decree names foreign subsoil users as subjects of subsoil law, and these may include foreign citizens, foreign

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legal entities, foreign states and international organizations (Article 11(2)).

Foreign nationals and legal entities may make use of the laws and bear the responsibilities in subsoil use on an equal basis with citizens and legal entities of the RK, if not othewise provided by the Decree or other normative acts (Article 4(4)).

The only difference for foreign and national subsoil users is contained in Article 68(2) of the Decree, which guarantees compensation for requisition of minerals either in kind or by payment of their value in freely convertible currency to a foreign subsoil user, but in the national currency to a national subsoil user.

The Decree does not contain a procedure for resolving disputes concerning subsoil use (as does the decree "On Oil"), which may raise questions among foreign investors. Such disputes must be resolved in accordance with Article 27 of the RK law "On Foreign Investments."

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Working With Kazakstan's Law on the Subsurface

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The final major legislation enacted by the President of the Republic of Kazakstan under the extraordinary executive powers, which he exercised until the new Parliament convened on 30 January, 1996, is the Edict on Subsurface and Subsurface Use ("Edict" or "Law on Subsurface"). This Edict, issued on 27 January 1996 and effective as of 29 January 1996, has the same legal force as legislation.[1] The prior Code on Subsurface and Processing of Mineral Raw Materials dated 30 May 1992 was abolished, although much of the prior Code already had been significantly modified by other presidential Edicts, including the Edict on Petroleum, the Edict on State Regulation of Relations Associated with Precious Metals and Precious Stones, and the Edict on Licensing. In addition, governmental resolutions already provided the framework for issuing licenses and concluding government contracts for the exploration and development of mineral resources. The Law on Subsurface incorporates such licensing and contract requirements for subsurface use and resolves several issues that previously posed problems for foreign investors.

The Law on Subsurface should only be considered as a framework. It provides a certain amount of freedom for foreign investors, with the consent of the authorized government body, to define the conditions for developing mineral resources in the Republic of Kazakstan. The Government has been charged with preparing a model contract on subsurface use operations, which may create further restrictions. The Government also must prepare before 1 July 1996 additional procedures for licensing and concluding contracts. Finally, special legislation may be enacted regulating the development of specific minerals.

Scope of Edict

This Edict applies generally to all subsurface use operations, which are defined as work relating to the state geological study of the subsurface, exploration and production (including work relating to underground water and therapeutic muds), exploration of the subsurface for discharge of sewage water, as well as work associated with construction and operations of underground facilities not associated with production. Although this definition is broad enough to incorporate petroleum operations, it was not intended that the Law on Subsurface supersede the Law on Petroleum. Investors in the petroleum industry should, however, take special notice of possible conflict between the Law on Subsurface and the Law on Petroleum.

Ownership of Subsurface and Raw Materials

In accordance with the Constitution, the subsurface is owned by the Republic of Kazakstan. Subsurface users initially acquire the "right to own" mineral raw materials by obtaining a license issued by the Government and by entering into a contract with the authorized government body. The Edict defines the term "mineral raw materials" as any part of the subsurface that is extracted to the surface (rocks, ore materials, etc.) and that contain useful minerals. Useful minerals are natural mineral substances in solid, liquid or gaseous state (including underground and therapeutic muds) suitable for utilization in production. The "right to own" is defined in the civil legislation and in this case means the right to use and dispose of the mineral raw materials. Processing of mineral raw materials is not considered subsurface operations and is, therefore, not governed by the Law on Subsurface.

Any individual or legal entity has the right to be a subsurface user, and foreigners are afforded the same rights and responsibilities as Kazakstani citizens and legal entities, unless otherwise stipulated in the legislation.

Government Authorities

The Government (Cabinet of Ministers) is designated as the licensing body. Since August 1994, when the licensing procedures for the right to use the natural resources of the Republic of Kazakstan were established, the Ministry of Geology and Preservation of Underground Resources has

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been responsible for negotiating and preparing licenses on behalf of the Government for both mining and oil and gas. The Ministry of Geology coordinates with an interdepartmental committee charged with reviewing and approving licenses as well as contracts. This procedure will probably remain in place in the near future and is helpful to foreign investors in obtaining appropriate approvals required for executing contracts with ministries and other government authorities.

The authorized body is delegated the authority to negotiate and conclude contracts for exploration and/or development of the subsurface. The authorized body should be a member of the interdepartmental committee. This body is also charged with preparing expert evaluations, monitoring compliance, and annually reporting to the licensing body the status of the contracts. Currently, the authorized body is the Ministry of Industry and Trade for mining projects, except coal and uranium. The Ministry of Oil and Gas is the authorized body for oil and gas.

Local executive bodies have rights to participate in license and contract negotiations and are frequently members of the interdepartmental committee. The local executive body is the authorized body responsible for granting land plots and for issuing licenses and executing contracts for commonly occurring useful minerals, such as sand and clay.

Licenses

Licenses under the Law on Subsurface may be issued on the basis of a tender (open or closed) or by direct negotiations with the Government. There are four types of licenses: exploration, production, construction and/or operation of underground installations not associated with production, and combined exploration and production licenses.

Exploration licenses are issued for a period up to six years with two two-year extension periods. Upon finding a commercial discovery, the licensee has the exclusive right to receive a production license, provided the licensee has complied with the terms of the exploration license. Prior legislation only provided the licensee with a priority right to a production license. A license must contain terms for the relinquishment of 50 percent of the exploration area during the term of the license, excluding any commercial deposit. A commercial deposit is defined as a discovery within the licensed territory of one or several deposits which are economically feasible to produce.

Production licenses are issued for a period up to 25 years. Combined licenses may be granted for a period that includes both the terms for exploration and production licenses. These periods are greater than prior legislation, and allow for extensions upon notification 12 months prior to the license expiration. The licensee must pay a license levy for the extension. The amount of this levy will be determined in subsequent regulations. The new Edict gives the licensee a priority right to carry out negotiations to extend the term of the license and of the contract.

Significantly, the new Edict provides for assignment of licenses with the written consent of the licensing body, which consent is required except when the assignment is to a subsidiary of the subsoil user. Prior legislation prohibited any assignment of a license, including assignments as security for financing, and licenses had to be terminated and reissued upon reorganization of an entity. Assignments of licenses must be made in accordance with the civil legislation. A specific provision of the Edict restricts loans under pledge to be used only for the purposes stipulated in the license.

Licenses may be suspended for up to six months for noncompliance with the license or contract or for a serious violation of the legislation of the Republic of Kazakstan. The licensee, however, is entitled to written notification and a reasonable period to cure. If the licensee fails to cure the default, the licensing body has the right to permanently revoke the license.

Contract

Upon issuance of a license, the licensee must negotiate a contract with the authorized government body. The terms of the contract may not contradict the provisions of the license, must be made in accordance with applicable legislation, and are subject to the provisions of a model contract. In June 1995, the Government published a model contract for the development of useful mineral deposits. The model contact was apparently drafted to apply only to state-owned organizations, but in the published form it is not so limited. This Edict, however, requires the Government to draft a new model contract for subsurface use by 1 July 1996.

Exploration and production operations may be performed under contracts for production sharing, concessions, services, and joint operations without any requirement to form a legal entity). Other types of contracts may also be considered depending on the conditions of the specific subsurface operations. All contracts must be approved by special executive bodies authorized on issues of environmental protection, health protection, sanitation, subsurface protection, and mining supervision. In addition, all contracts are subject to an economic, ecological and legal expert evaluation, as well as tax expert evaluation. Edict of the President, No. 2703, dated 21 December 1995.

Grandfathering Clauses

It is significant that the new Edict confirms that contracts entered into and licenses issued prior to the effective date of the Edict remain valid. In addition, amendments and additions to legislation that worsen the position of the subsurface user will not apply to licenses and contracts issued and concluded prior to such amendments and additions. Foreign investors should specifically incorporate legislative provisions in their contracts including the above grandfathering clauses. Despite the grandfathering clauses in the foreign investment law, many foreign investors have faced difficulties convincing authorities that their contractual provisions are

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enforceable when they contradict the current legislation. By incorporating specific provisions in the contract, investors should obtain maximum assurances that they will be recognized by the appropriate authorities without having to resort to arbitration or other proceedings.

Land Plots

The subsurface user must obtain a land plot granting the subsurface user the right to use the surface. Under the Edict, the subsurface user is entitled to be granted a land lot in accordance with the license, the contract and applicable land legislation. The land plot is issued by the relevant local executive body.

Taxes and Other Payments

Except for commonly occurring useful minerals, all rights to use the subsurface are temporary and subject to payments. The Edict requires payments for participation in tenders and purchasing geological information. The Edict on Taxes and Other Mandatory Payments to the Budget dated 24 April 1995 ("Tax Code") requires land rental payments and special payments for subsurface use, including a contract signature bonus, a commercial discovery bonus, production bonuses, which are based upon reaching certain levels of production, royalties and excess profits taxes. Other levies and payments may also be required. Payments for subsurface use are currently negotiated with the authorized body based upon economic projections of the project. The Government is currently considering adding new provisions to the Tax Code that would determine the taxation payments for subsurface use.

Additional Provisions

A few additional provisions should be noted:

• Licenses issued to foreign investors have always required a provision that the licensee will give priority to hiring Kazakstani personnel, to purchasing Kazakstani-made equipment, and to using Kazakstani services. Many foreign investors have requested that such provisions be limited by standards of competitiveness and reliability. The Edict codifies these standards.

• The Law on Subsurface provides that the parties may agree that the contract be governed by the laws of other jurisdictions, except as directly stipulated in the legislative acts of the Republic of Kazakstan.

• The Law on Subsurface introduces standards of operations based on standards acceptable in international practice.

• The Edict provides for significant supervision by and reporting to the Government.

• The Republic of Kazakstan has a preemptive right to purchase useful minerals out of the share of the foreign subsurface user at prices that do not exceed international market prices. The maximum volume of minerals to be purchased, the procedure for setting the prices and form of payments are to be stipulated in the contract. The Government has the right to requisition any useful minerals during emergency circumstances with guaranteed compensation for such requisitions in kind or by money payment in freely convertible currency at market prices on the date of the requisition.

[1] On 1/30/96, the new Parliament convened and the President no longer has authority to issues edicts with the force of law.

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General Characteristics of the Decree

Definition of a Special Economic Zone

Article 2 of the Decree defines a special economic zone as a restricted territory of the RK on which a special legal regime exists.

A special economic zone is created for a set period of time by edict of the President of the RK upon recommendation of the government of the RK, based on a proposal of the local representative and executive authorities. The presidential edict creating the zone will include provisions regulating the procedure for the formation and activities of the organs of administration on the territory of the zone, the formation of the budget, the procedure and time periods for the abolition of the zone, and other questions.

Purposes for Creating Special Economic Zones

Purposes for creating special economic zones set forth in the Decree include accelerated development of regions to promote the entry of the economy of the RK into the system of world business connections, the creation of highly efficient export-oriented production, learning how to produce new types of goods, the attraction of investment, finishing work on the legal norms of market relations, instilling modern methods of managing and conducting business, and also the resolution of social problems (Article 3).

Lack of Implementing Legislation

However, such goals can hardly be realized through this Decree, insofar as it does not contain sufficient legal instruments for this.

For comparison, note that the majority of norms in the 1990 Law regulating the special features of the legal regime for free economic zones had direct effect. The provisions of this Law separately regulated questions of currency and financial/credit mechanisms on the territory of the free economic zones; taxation; labor relations; and the procedure for the creation and activities of foreign legal entities.

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In the present Decree, the majority of the articles have a reference character, i.e., their meanings must be searched for in other legislative acts.

However, because of the headlong development of Kazak legislation, the legislative and executive authorities frequently are in no hurry to issue special normative acts (instructions, provisions) or to introduce revisions in existing ones to establish procedures to effectuate this or that norm of a law. This, as a rule, leads to many problems.

Currently, the only legislative act containing a special chapter on matters of customs regulation of special economic zones is the decree of the president of the RK having the force of law "On Customs Matters in the Republic of Kazakstan" of July 20, 1995. This decree refers to tax legislation establishing a preferential tax regime for businesses registered on the territory of the special economic zone. Such a regime for special economic zones has yet to be established.

With regard to several types of activities (banking relations, licensing, etc.), special legislation referenced in the Decree has not been put into place: normative acts of the RK do not provide for any special legal regime or privileges on the territory of a special economic zone. Banking and licensing activities on the territory of a zone are carried out in exactly the same way as in any other part of the RK.

Advantageous Provisions of the Decree

The Decree has many positive features.

More attention is given to guarantees of the rights of businesses on the territory of the special economic zone. Article 6, which is devoted to this, provides that in the case of changes to the legal regime or the legal boundaries of the territory of the special economic zone, or its abolition, businesses that have made investments on the territory of the zone are guaranteed the right to continue their activities under the same conditions as when they invested -- until the termination of the period for which the zone was to exist, but no more than 10 years.

The Decree simplifies the procedure for creating special economic zones. Whereas, previously they were created by decision of the Supreme Soviet of the RK under a rather lengthy procedure, now special economic zones are created by decree of the president of the RK upon recommendation of the government.

Additionally, the Decree introduces special Article 16, which regulates the procedure for changing the conditions and the administration of special economic zones.

The Administration of a Special Economic Zone

An administrative council headed by a chairman governs on the territory of a special economic zone. The administrative council is a legal entity, Article 7(3).

The procedure for forming an administrative council and a description of its duties are found in Article 7(1).

The powers of the administrative council include:

- elaborating and putting into effect a program for developing the special economic zone;
- setting up the financial fund (budget) of the zone;
- attracting investments and credits;
- passing resolutions needed to open representative offices of the administrative council beyond the borders of the zone;
- registering businesses seeking to carry out activities on the territory of the zone; and
- representing the interests of the zone in state agencies.

The administrative council also has other authorities, Article 8(9).

Peculiarities of the Legal Regime Of a Special Economic Zone

Finances

The administrative council of the zone forms a financial fund for taxes, fees, and other mandatory payments. If the boundaries of the zone coincide with the boundaries of an administrative territorial unit, a budget is created that is simultaneously the budget of the administrative territorial unit, Article 9(1). The provisions on the special economic zone set forth the procedure for setting up the fund.

Interactions of the financial fund (budget) with the aforementioned budget are determined through the method of making deductions from the total amount of revenues of the special economic zone, Article 9(3).

The administrative council may set up special-purpose financial funds at the expense of free budget moneys and deductions, and also fees of a nontax character.

State Registration of Businesses on the Territory of the Zone

State registration of legal entities created on the territory of a special economic zone is done by the authorized agency of the Ministry of Justice of the RK directly on the territory of the zone, Article 13. The Decree establishes no special provisions for creating and registering legal entities on the territory of special economic zones.

Procedure for Stays of Foreign Nationals in the Special Economic Zone

Article 15 of the Decree provides that the general procedures for entry, exit, transit, and sojourn established by legislation of the RK apply to special economic zones.

Central executive agencies are to create separate subdivisions to register the entry, exit, transit, and sojourn of foreign nationals, and their means of transportation, on the territory of the zone.

Customs Regulation of the Zone

The territory of the special economic zone is considered to be located outside the customs territory of the RK in a free customs zone.

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Under Article 71 of the presidential decree having the force of law entitled "On Customs Matters in the Republic of Kazakstan," a legal regime prevails on the territory of the zone, which permits the distribution and use of foreign goods without the collection of customs duties and taxes.

This norm currently is, in essence, the only one giving real economic privileges to businesses carrying out activities on the territory of a special economic zone.

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The General Meeting of Shareholders

Part I of the Civil Code of Russia, which was signed in late 1994, made progress in defining the roles of various governing bodies of a corporation in Article 103, *Administration of a Joint Stock Company*. Point 1 placed five matters within the "exclusive competency of the general meeting of stockholders," namely:

1) amending the company charter, including changing the amount of charter capital;

2) electing members of the board of directors and the auditing commission and terminating their duties;

3) forming executive bodies of the company, if the charter does not delegate this to the board of directors;

4) approving the annual reports, bookkeeping balances, statements of profits and losses, and distribution of profits and losses; and

5) deciding to reorganize or liquidate the company.

Article 103 of the Civil Code provided that the JSC Law (then only in draft) could expand the exclusive competency of the shareholders' meeting. Furthermore, it barred the general meeting of shareholders from transferring matters in its exclusive competency to the executive bodies of the company.

Article 48 of the JSC Law greatly expanded the matters within the exclusive competency of the shareholders' meeting to cover 18 areas, including the approval of interested party transactions, Article 48.1(17), and the approval of large deals, Article 48.1(18). Other additions to the exclusive powers of the general meeting of shareholders include: determining the maximum number of authorized shares and deciding whether to split or consolidate shares.

Matters that the JSC Law places within the exclusive jurisdiction of the general meeting of shareholders may not be transferred to the board of directors for decision, with the exception of changes to the company charter to increase its statutory capital, Article 48.2. However, Article 48.1(8) permits the founders to write the charter so as to delegate the power to form and terminate the executive body of the company to the board of directors.

Other powers conferred on the general shareholders' meeting by Articles 48.1(19)-(21) of the JSC Law are nonexclusive in character. These include:

- acquiring and purchasing distributed shares on behalf of the company;
- approving participation in holding companies, financial-industrial groups, and other unified commercial companies;
- resolving other questions specified by the JSC Law.

If the shareholders' meeting passes an enabling resolution, the board of directors can decide questions within the nonexclusive competence of the shareholders' meeting. The final catch-all phrase that allows the general meeting of shareholders to decide or delegate "resolving other questions specified by the JSC Law" may permit delegation to the board of directors of decisions as to their own compensation and that of their staff, and other important matters.

Article 11.3 of the JSC Law, which states that provisions of the company charter may not "contradict the present federal law or other federal laws," prevents the founders of a company from using the charter to vary the exclusive powers conferred on the shareholders' meeting by Article 48 in any way not permitted by the terms of that Article.

The Board of Directors and The General Director

Article 65 of the JSC Law lists 19 matters, relating to the general management of company operations, that are within the exclusive competence of the board of directors. In contrast to the provisions governing the general shareholders' meeting, Article 65 does not authorize the board of directors to delegate any of the matters within its exclusive competency. In the past, the board of directors may have referred to the general shareholders' meeting questions on which they could not agree. Now they must make their own decision if the matter comes within their exclusive competence.

As compared to the prior law, the exclusive powers of the board of directors are expanded. For example, Presidential Decree No. 721 of July 1, 1992, Part IV, Para. 9.3 empowered the board of directors to *approve* large corporate transactions. Article 65.17 authorizes the board of directors to *"conclude* major deals associated with the acquisition and cession of property by the company." This contemplates a more hands-on role for the board of directors. Moreover, the board is no longer the highest management organ in the interval between general shareholder meetings (as it was described in Article 108 of the Provisions on Joint Stock Companies), rather it is responsible on a full-time basis for the general management of the company, Article 64.1.

The powers assigned to the executive organ of the company and to the company's general director may be spelled out in the company charter or in the contract concluded with that person, Article 69 of the JSC Law. The latter option gives the board of directors the flexibility to circumscribe the powers of a general director who is new and inexperienced or, on the other hand, to give freer rein to a general director who is an experienced and a trusted manager.

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CONFERENCE CALENDAR

March 27 & 28, Pharmaceuticals and Healthcare in the RF, Ukraine, and Belarus

Grand Hotel Europe, St. Petersburg
Sponsored by the Adam Smith Institute
Call Nicola Abbott in London
Tel: 44-171-490-3774

March 27 & 28, Telecommunications in the Russian Federation, Ukraine, Belarus, Armenia, Georgia, and Moldova

Penta Renaissance Hotel, Moscow
Sponsored by the Adam Smith Institute
Call Cristina Watts in London
Tel: 44-171-490-3774

March 28-29, Russian Tax, Investment and Banking Climate: Impact on Western Business

Law Office of Patterson, Belknap, Webb & Tyler, LLP. NYC
Sponsored by the Geonomics Institute and the International Tax and Investment Center
The event will convene senior Russian officials from MinFin, the State Tax Service, Central Bank, and the Duma together with Western businessmen, attorneys, and accountants to discuss Russia's investment climate.
Contact Charlotte Tate
Tel: (802) 388-9619
Fax: (802) 388-9627

March 28 & 29, Trade and Investment Opportunities in the Russian Oil Industry

Hotel Intercontinental, London, U.K.
Sponsored by the Royal Institute of International Affairs
Chatham House, 10 St. James Square, London SW1 4LE, U.K.
Tel: +44-171-957-5700
Fax: +44-171-321-2045/957-5710

March 29-31, The Russian Elections: How Will Growing Nationalism Affect Investment?

Harvard-Columbia Arden House Conference, NY
Sessions will focus on Russian taxes, privatization, crime, investment funds, banking, financial markets, and the experience of Western oil companies.
Tel: 212-854-4623 (W. Averell Harriman Institute at Columbia)
Tel: 617-495-8900 (Harvard's Russian Research Center)
Fax: 617-495-8319

April 1, U.S.-Russian Trade and Investment Forecast, 1996

Four Seasons Hotel, Washington, D.C.
Sponsored by the U.S.-Russia Business Council
Tel: 202-739-9180
Fax: 202-659-5920

April 17-20, International Congress: Investment Opportunities in Construction, Ecology, St. Petersburg, Russia

Sponsored by Business Prosperity International
Large-scale projects, such as reconstruction of the city's airport, seaports, road construction, reconstruction of the historical city center will be presented to foreign investors.
Tel./Fax: +7-812-272-0213/275-3602/279-1038

OIL (continued from page 1)

a rise in excise taxes will do to the domestic oil industry. Whereas, overall oil production in Russia has been declining, *Rossiyskaya Gazeta* reports that the volume of oil exported to "the far abroad" has increased by 13 percent since 1994. About 40 percent of foreign capital investments in Russia, both direct and portfolio, enter the area of oil production for export, and the amount of oil sent abroad by joint ventures and foreign enterprises in Russia rose from 8 percent of total oil exports to 14 percent. About 35 percent of the oil produced in Russia is exported, and Russian oil, reportedly, has been selling at prices 10 to 12 percent below world prices.

Export duties, which are being lifted, are levied only on exported oil. Excise taxes, however, are imposed on all oil extracted. Thus the price of domestic oil will rise. The rise in the price of exported oil will be offset by the absence of export duties, thus placing domestic and export sales on a par. Since payment by foreign consumers is more assured than payment by consumers in Russia and "the near abroad," i.e., CIS countries, exports to non-CIS markets will be favored.

One plan, reported by *ITAR-TASS*, is to cut the export duties on oil from 20 to 10 ECU per metric ton on April 1 and abolish them altogether on July 1, causing an 8 trillion ruble ($1.7 billion) deficit in the budget. This short-fall would be made up by increasing excise taxes from the current 39,000 rubles ($8) per metric ton to 55,000 on April 1 and to 70,000 on July 1. Russian Minister of Fuel and Energy **Yurii Shafranik** told a news conference that he opposes these measures because they will harm domestic energy consumers.

First Deputy Prime Minister **Vladimir Kadannikov** agreed that increasing only the excise tax as proposed would raise gasoline prices by 30 percent and cause inflation. He announced a plan to raise excise taxes to a level that would only compensate for 3 ECU of the lost 20 ECU per ton export duty. The rest of the budget loss would be made up by imposing a tax on oil pumping in pipelines and by increasing tax collections. [*Rossiyskaya Gazeta* estimated that only 40 percent of excise taxes due were actually being collected.]

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Text of the Russian State Tax Service's Explanation of Instruction No. 34

Translated by Al Celmer, Esq.

"Methodical Recommendations on the Use of Certain Provisions of the Instruction of the State Tax Service of Russia of June 16, 1995, No. 34 'On the Taxation of Profits and Revenues of Foreign Legal Entities,'" RF State Tax Service Letter of Dec. 20, 1995, No. NP-6-06/652.

In connection with questions received from taxpayers, tax authorities, and auditing firms, the State Tax Service of the Russian Federation issues methodical recommendations for using certain provisions of the Instruction of the State Tax Service of Russia of June 16, 1995, No. 34 "On the Taxation of Profits and Revenues of Foreign Legal Entities."

The aforementioned Instruction was registered by the Justice Ministry of Russia on July 7, 1995 under No. 897 and was officially published July 27, 1995 in the newspaper "*Rossiyskiye Vesti*," No. 139(812).

The Instruction's statement that every construction site forms a separate permanent representation for tax purposes does not apply to foreign firms covered by a dual taxation treaty.

The Instruction lays out the basic principles in accordance with which the activities of a foreign legal entity in the RF independently or through other persons will be considered by the tax authorities to be a "permanent representation." The term "permanent representation" is used only for determining the tax status of the foreign entity and does not have organizational or legal meaning.

When there is an agreement on the avoidance of dual taxation of revenues concluded by the USSR or the Russian Federation with a concrete foreign government, other criteria and approaches may be used to determine the presence or absence of activities falling under the concept of "permanent representation."

The Instruction indicates that every construction site shall be considered as forming a separate permanent representation from the moment work commences. This norm is based only on internal legislation of the Russian Federation and does not relate to construction sites of foreign firms of those countries with which the RF (USSR) has an active agreement on the avoidance of dual taxation.

The Instruction establishes a number of provisions determining the basic principles for registering foreign legal entities with the tax authorities. In particular, it is provided that foreign legal entities carrying out business in the RF are obliged to register with the tax authorities independent of whether or not their activities will in the future be recognized by the tax authorities as subject to taxation. That is, the basis for registration with the tax authorities is the fact itself that the foreign legal entity has commenced activities in the RF, and not the presence or absence of tax obligations in accordance with internal legislation or international agreements.

Another principal provision is the obligation for the foreign legal entity to register with the tax authorities at the place in Russia where activities are being carried out. Foreign legal entities that carry out activities in various locations on the territory of the RF must register with the appropriate state tax inspectorate at the places where activities are being carried out.

The Instruction introduced a provision on [the duty] of a foreign legal entity (or its authorized representative) having a source of passive revenue on the territory of the Russian Federation to give notice of sources of revenue to the tax authorities. In particular, passive revenues include interest, dividends, and license payments.

Revenues connected with the carrying out of any sort of activity in Russia, for example, doing construction and assembly work, performing commercial intermediary operations, rendering any kind of service, etc., are classified as so-called "active" revenues.

Notice must be given within a month from the moment the right to receive the revenue arises. The date the right to revenue in the form of dividends or other distributions of profits arises is considered to be the date when an authorized body of the enterprise (organization) adopts a decision to distribute the profits. In other cases, the date the right to receive revenues arises may be considered to be the date a contract (agreement) providing for the payment of passive revenues is concluded.

Where there are several sources of revenues on the territory of Russia, the foreign legal entity may include in each notice either one or several such sources.

Subdivisions of foreign legal entities on the territory of the RF that carry out activities through permanent representations shall keep registers of bookkeeping calculations, such as journals, ledgers, working registers, cashbooks, and others, as independent commercial subjects. However, this does not mean that such registers must be kept in accordance with the rules prevailing in the Russian Federation, that is, they may be kept according to the rules set down by the head office.

Bookkeeping registers and forms for tax calculation may be maintained and stored abroad, under the condition that they be presented at the first demand of the tax authorities within a time period acceptable to them. These time periods must be set on the premise that bookkeeping documents in the obligatory order are at the head office, do not need additional preparation, and that the time is necessary only to receive a request from the subdivision and to deliver the documents from abroad in the usual order.

(See **INSTRUCTION** on page 14)

INSTRUCTION (continued from page 13)

If these conditions are not fulfilled, the tax authorities may demand that the subdivision keep its accounts and store its documents in the Russian Federation.

All numerical values in calculation and accounting forms established by the Instruction (declaration, forms, registers) shall be indicated only in rubles.

For subdivisions of foreign legal entities on the territory of the RF whose activities do not result in the formation of a permanent representation, tax accounts may be kept in a simplified form.

A company that has several construction sites within one tax inspectorate may not consolidate bookkeeping if the sites constitute separate permanent representations.

Tax calculation forms established by the Instruction shall be kept in the obligatory manner starting from Oct. 1, 1995.

Where a foreign legal entity, in accordance with Point 3.2.1 of the Instruction, appeals to the tax authorities to obtain approval to keep his tax accounts in simplified form, the corresponding tax agency shall consider that appeal within a month and shall officially communicate its opinion to the applicant in written form.

If there are several construction sites, resulting in the formation of a permanent representation, existing on the territory of a single inspectorate, calculations must be done as to each separate place where such activity is performed. Consolidation of bookkeeping and tax calculations of the same legal entity as regards several permanent representations is not permitted.

In accordance with the Instruction, the tax on the profit of a permanent representation of a foreign legal entity that performs construction and installation work shall be paid annually.

If the actual period of existence of a construction site exceeds the period established in an agreement on avoidance of double taxation in the course of which the existence of the construction site does not lead to the formation of a permanent representation, then the calculation of tax obligations with regard to the profit tax shall be done at the first accounting period that arrives after the period was exceeded, based on the total volume of work completed from the beginning of the existence of the construction site.

The Instruction clarifies individual provisions connected with the calculation of tax obligations.

Thus, expenditures of a permanent representation for the maintenance of any subdivisions of a foreign legal entity not located on the territory of the Russian Federation, including subdivisions of the head office, shall not be taken into account when determining profits.

Individual types of expenditures determined by the Provisions on the Expense Structure for the Production and Sale of Products (Work, Services) and on the Procedure for Formulating Financial Results Taken Into Account in the Taxation of Profits, approved by the Resolution of the RF government of Aug. 5, 1992, No. 552, along with the changes and additions introduced into it by the Resolution of the RF government of July 1, 1995, No. 661, are included in the expense structure of a permanent representation within the bounds of the norms established by legislation of the Russian Federation.

The basic method for calculating the profits of a foreign legal entity that is carrying out activities in the RF through a permanent representation is the direct method, that is, by determining profit as the difference between the proceeds from the sale of products (work, services) and the expenses for its production.

If it is not possible to directly determine the profits received by a foreign legal entity from any of the activities carried out by it in the RF, then a series of conditional methods are provided for determining the profits from any type of activity [and] permitting determination of tax obligations by an estimated method.

Thus, if the expenses for the activities of a foreign legal entity through a permanent representation cannot be determined, the tax agency may calculate profits conditionally, based on the income that the foreign legal entity received in connection with such activity.

If it is not possible to determine the income of a foreign legal entity received in connection with the performance of any type of activity in the RF, the tax agency shall calculate profits conditionally based on the gross income of the foreign legal entity from all sources, one of which being activities in the RF, based on the ratio of the number of personnel of the representation in the RF to the overall number of personnel of the foreign legal entity.

If it is not possible to determine the income of a foreign legal entity from all sources, one of which is its activities in the RF, the tax agency shall calculate profit conditionally, based on expenditures connected with such activities.

The total taxable profit of a permanent representation from all types of activities is determined by adding profits determined by direct and indirect methods.

When including in the income structure of permanent representations the full amount of revenues received from sources in the RF and subjected to advance taxation when paid out, the foreign legal entity counts the amount of taxes paid earlier.

If the permanent representation sends information to

(continued on next page)

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