ONSHORE/OFFSHORE CONTRACT STRUCTURES: CHALLENGES FOR THE OIL INDUSTRY

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Since independence, the oil and gas sector in Kazakhstan has been characterised, more than any other industry in the country, by successful combinations of local and overseas organisations.

Whether in the form of strategic joint venture investments or more short-term commercial arrangements, one constant factor which features in the relationships between these local and foreign businesses is invariably taxation and, specifically, the quest to achieve a stable and predictable taxation profile in relation to the arrangements in question.

Kazakhstan's taxation framework, featuring an active and engaged taxation authority in addition to a constantly evolving and much amended taxation code, makes the achievement of such taxation objectives a unique challenge.

The highly specialised nature of this industry, combined with the fact that many of the centres of excellence in terms of oilfield service expertise are located outside Kazakhstan, means that most exploration and production companies operating in Kazakhstan also place significant reliance on overseas subcontractors.

When engaging with operators in Kazakhstan, most subcontractors endeavour to do so whilst maintaining core activities and functions (which are employed to service Kazakhstan counterparties) in their home country of operation. Whilst some degree of local presence is invariably required, a significant proportion of subcontractors often strive to minimise local footprint and, consequently, to limit their Kazakhstan tax exposure to the taxation of only those operations taking place in Kazakhstan itself.

The net outcome of such subcontractor objectives in terms of contractual structure is, therefore, that contracts often set out either that:

- the services in question will be provided entirely offshore (i.e. remotely from an overseas jurisdiction);
- a portion of services will be provided in Kazakhstan with the remainder provided from an overseas location;
- multiple contracts are concluded to govern work to be undertaken in Kazakhstan and carried out overseas (respectively).

From the perspective of such overseas subcontractors, invariably the primary taxation objective is being able to achieve the targeted contractual taxation profile and to be capable of understanding in what jurisdiction, in which proportion and at which rate income and profits will be taxable.

The Kazakhstan counterparties of such subcontractors, however, have as their own core concern their compliance with local taxation obligations –specifically those placed upon them as "tax agent" in relation to payments made to overseas subcontractors.

Whilst the goals of the two groups ought not be mutually exclusive, experience of the Kazakhstan taxation landscape shows that, all too often, the issues in point are not adequately addressed (in a collaborative manner) between client and subcontractor organisations until the arrangements and contracts in question have become problematic with relation to the appropriate taxation analysis and where parties are in disagreement as to when and where taxation should be applied and declared.

The nexus of such conflicts between contractor and subcontractor often lies in ambiguity in the local interpretations of both the Tax Code and generally accepted international taxation principles (such as those set out in double taxation treaties). The degree of ambiguity is compounded by the absence of any extra statutory guidance available in Kazakhstan as to the appropriate interpretation of domestic and international tax laws.

The Kazakhstan taxation landscape is also often characterised by inconsistent application of provisions between various tax authorities and regions. As such, achieving stable and predictable tax compliance in Kazakhstan remains a challenge for both local and international investors.

From the tax agent perspective, the difficulties in managing the associated risks relating to contracts with overseas counterparties are derived from the following factors:

- Are the services in question subject to withholding taxes in Kazakhstan in line with the domestic Tax Code (i.e. do the services in question fall so as to be classified as giving rise to "Kazakhstan source income")?
- Is the counterparty able to benefit from any available double taxation treaty?
- Have all treaty application formalities (as set out in domestic tax law) been complied with?
- How should the income in question be treated under an applicable taxation treaty?
- Have the services in question been provided in whole or in part in Kazakhstan?
- Has this "onshore" activity given rise to a permanent establishment ("PE") of the overseas organisation in Kazakhstan?
- If a PE has been created, has this PE been properly registered (or incorporated and registered) with the Kazakhstan taxation authorities?
- If properly registered, has income been suitably attributed to the PE and contracted/invoiced from this PE?

Experience in Kazakhstan shows that, invariably, if the tax agent in question cannot obtain suitable comfort as to the correct answers to (some or all of) the above questions, then their approach will ultimately be to withhold tax (at rates applicable under local legislation which can be up to 20%) from payments made to the overseas counterparty.

One important point for non-residents to understand (in relation to the application of double taxation treaty benefits) is that, under local law, the advance application of such relief (by tax agents in Kazakhstan) is a right available to tax agents but not an obligation.

Accordingly, insofar as tax agents believe they are exposed to taxation risks, they are entitled to not apply treaty reliefs and practice shows that this will invariably be the policy adopted by agents who believe they are at risk. (In such cases, non-residents retain the right to pursue treaty relief by applying to the local taxation authorities for a refund of taxes withheld and remitted).

In relation to treaty relief qualification formalities, it is crucial to note (as an overseas organisation) that no automatic treaty relief applies in Kazakhstan. There are prescriptive requirements that must be satisfied in terms of evidencing tax residence and treaty entitlement. These formalities should be complied with on an annual basis and all overseas companies should ensure that evidence

provided to counterparties is exactly in line with requirements as any deviations will often be used (by the authorities) to reject the application of treaty relief. Consequently, any such deviations will often lead to no relief being applied by Kazakhstan-resident tax agents.

From the perspective of permanent establishment creation, the key issue for non-residents to be aware of is the fact that both local and treaty law set out criteria for the recognition of a PE.

The tests set out in the domestic Tax Code, however, are more broadly drawn and a PE is recognised (in line with one of the tests) after overseas company personnel have been in-country for in excess of 183 days in a twelve-month period (irrespective of whether such individuals are operating from a "fixed place of business" or carrying on the non-resident's business in whole or in part).

Accordingly, insofar as the authorities are able to prove (or if a tax agent is not convinced) that treaty application formalities have not been suitably satisfied by the non-resident, then treaty relief would not be applied and the PE tests under local legislation would be enforced.

Insofar as treaty protection is available, the tests for PE creation set out in the relevant double taxation treaty would be applied. However, it should be clearly noted that the local tax authorities are often aggressive in relation to challenging non-residents' tax status in Kazakhstan (i.e. determining the creation of such non-residents' potential PE in country).

Prolonged periods spent in Kazakhstan by non-residents' employees, working from client sites, undertaking (even portions of offshore) contractual activity increase the risk that either the authorities or (more immediately) the relevant tax agent will assert that the non-resident has created a PE that should be registered in Kazakhstan.

Kazakhstan's Tax Code also contains a "force of attraction" principle which operates so as to attribute any income of a non-resident organisation and local branch of the same entity insofar as both the branch and non-resident are engaged in the provision of similar services. The effect of such an attribution would, invariably, be to lead to the Kazakhstan tax agent withholding the full local rate of 20% on all income (on the basis that the attributable income is not contracted by and invoiced from the branch in question).

To the extent that an onshore/offshore contract structure is used, the most common issues that must be robustly managed would often be:

- Ensuring that contracts executed are sufficiently clear to support both the allocation of income to onshore and offshore parties in addition to being capable of explicitly supporting the fact that offshore services do not take place in Kazakhstan;
- Tracking both days spent in country and activities undertaken in country by representatives of the "offshore" contractor to ensure associated PE risks are understood and suitably managed;
- Onshore and offshore contracts being concluded by a non-resident legal entity and the same entity's own Kazakhstan branch substantially increase the risk of (offshore) income being attributed to the local branch;
- Accordingly, concluding contracts in such a way to mitigate the risk of income attribution to any existing PE/branch in Kazakhstan (which would, in turn, lead to withholding tax on any attributed income);
- In addition to attributing income to a local PE/branch, it is also crucial to ensure that this PE/branch is explicitly set out as the contractual counterparty (and recipient of payments) in relation to onshore services provided.
- Income attributed to any local branch in Kazakhstan should remunerate such a branch as if it were a separate, independent legal entity. In broad terms (and in line with OECD and general transfer pricing principles) that is that the level of remuneration should compensate the branch for functions undertaken, risks borne, assets utilised as if this branch were an independent third party.

From a commercial and cash-flow perspective, it is clearly in the interests of non-resident counterparties to ensure that, where treaty relief ought to exempt (in whole or part) income paid to such organisations by Kazakhstan parties from WHT, then such relief is both available and suitably applied.

However, in order for the optimum relief to be applied in a timely fashion, it is necessary for overseas subcontractors to ensure that they address a number of issues and take certain actions which can, in broad terms, be summarised as:

- Engage (from a tax perspective) with your Kazakhstan-based counterparty at a sufficiently early stage. Ideally this should be at a point in time when contracts are being negotiated.
- Be realistic as to whether it is reasonable to assume that all work can be effected offshore or whether, in reality, there is a risk that activities undertaken in Kazakhstan will give rise to a PE of the overseas company;
- If a PE will potentially or likely be created, then proper consideration must be given to whether a decision is taken to accept this fact in advance and properly register and recognise such a taxable operation in Kazakhstan so as to secure a certain and controllable tax profile;
- Insofar as the work to be undertaken does comprise both onshore and offshore components then:
  - suitable efforts should be dedicated to allocating contractual income (and corresponding costs) in relation to the work to be undertaken in Kazakhstan and that to be carried out overseas;
  - supporting analysis and documentation should be put in place to support the above allocation;
  - contracts should ideally be separated into an onshore contract and offshore contract;
  - any onshore contract should be concluded between the Kazakhstan customer and the PE/Branch/local subsidiary of the overseas organisation. All related invoicing should come from this business unit and income should (again, ideally) be paid to a bank account in this unit's name in Kazakhstan;
  - seek sufficient advice so as to fully understand (and be able to commercially price into the relevant contracts) the effect of all local corporate income tax, WHT, branch profit tax, VAT and employment tax implications in relation to the contractual structure.

In summary, the operation of non-residents (contracting with Kazakhstan-resident organisations) remains one of the most hotly disputed areas between commercial counterparties and authorities alike.

Whilst, clearly, legislative ambiguity (and lack of guidance) does little to alleviate the problems inherent in such contractual structures, a suitably timed and collaborative approach between commercial partners and advisors alike could do much to eliminate or mitigate the degree to which this matter leads to significant and value-eroding commercial and taxation issues.